Behind IMF optimism on growth

Major imbalances in world economy

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The International Monetary Fund has released an optimistic forecast for world economic growth, predicting that the global economy is set to expand at its fastest rate in more than a decade. Releasing the IMF's World Economic Outlook on Wednesday, IMF chief economist Michael Mussa said world Gross Domestic Product growth in 1999 was 3.3 percent—a full percentage point greater than had been anticipated in December 1998 at the height of the financial turbulence precipitated by the so-called Asian financial crisis.

Next year, he said, the IMF predicted world economic growth to be as high as 4.25 percent, and possibly subject to an upward revision. “All areas of the world economy are contributing to the strengthening and growth prospects going forward,” he told a news conference.

But behind the headline figures on growth, the report itself points to major imbalances in the world economy, centring, in particular, on the United States.

The report said the main area of concern “stems from a series of economic and financial imbalances that have been building for several years.”

These included:

* The lopsided pattern of growth among the principal currency areas (the US, Europe and Japan) and “the resulting increase in external imbalances, with the US current account in record deficit and persistently large surpluses in Japan and, to a lesser extent, in the euro area. These imbalances appear unlikely to be sustainable, based on recent past experience. On a smaller scale, large external deficits also persist in Australia, New Zealand, most of Latin America, and among some countries in transition.”

* The risk that with large external balances there could be “sudden changes in market sentiment, associated shifts in capital flows, and potentially disruptive realignments of exchange rates.”

* The very high stock market valuations around the world. While these may be “justified in part by investors' favourable assessments of the impact of future technologies” they could also “reflect unrealistic expectations of future earnings growth that have been nourished by the now record-long expansion in the United States.” While part of the explanation for the rise in asset prices was due to the expansion of financial liquidity in the wake of the Asian and Russian crises of 1998, experience had shown that “asset price inflation can be particularly destabilising because it may encourage households and businesses to over-consume and over-invest, and because of the danger that the financial system may become vulnerable to an eventual downward correction in asset prices.” (In other words, the expansion of bank liquidity to prevent a financial collapse in 1998 may have led to creation of a global asset bubble.)

Reflecting the general bewilderment of almost the entire economics profession in the aftermath of recent financial turbulence, the report went on to say that it might be “tempting to conclude that since the perceived imbalances have not given rise to any obvious difficulties so far, they may not be a problem after all” and that such a view “has more than a few adherents.” However, it continued, “if it is wrong such complacency could have severe consequences” and “the potentially disruptive effects could become much more serious if the imbalances were allowed to increase further.”

Asked to comment further on the widening US current account deficit, now running at around $400 billion per year, and the possibility that a point would come when this deficit could no longer be financed by the inflow of foreign capital, Mussa said that while he did not have a “doomsday scenario”, the present situation was unsustainable.

“When we think about the sustainability of the US current account balance,” he said, “I think it's important to put that in a medium-term context. A US current account deficit of 4 percent of GDP running on for as long as the eye can see with the US net debtor position growing from 15 percent of GDP to 50 percent of GDP over the next decade and a half, that does not look like a sustainable scenario.”

According to Mussa, in order for the US current account deficit to be reduced from its present level of 4 percent of GDP to between 1 and 2 percent, domestic demand growth in the US economy would have to be reduced from its present rate of one percentage point above domestic output growth, to around three quarters of a percentage point below the increase in domestic output.

In other words “demand growth in the US economy” would have to be “significantly less rapid than what we've seen over the past two to three years.” While Mussa did not designate this turnaround as a “recession”, that is the clear implication of his remarks. Indeed some economists have likened such a slowdown to “hitting a brick wall.”

Another key feature of the report concerned the situation in Japan. According to the IMF, the recovery of the Japanese economy from recession remains “halting”. “After falling through much of 1997 and 1998,” the report noted, “real GDP rebounded in the first half of 1999, with private sector demand being buoyed by government spending. In the second half of this year this process went into reverse, however, with a decline in government investment being associated with a fall in private domestic spending.”

The economy contracted in second half of the year at an annual rate of 4 percent “as private consumption remained depressed by falling earnings and uncertainty about employment prospects” with the only bright spots an increase in business investment and reports of improvements in corporate profitability.

The report pointed out that with “recovery looking fragile” and amid “growing concerns about the fiscal situation” (Japanese debt is around 125 percent of GDP), as well as fears of deflation, the Bank of Japan had to continue its “zero interest rate” policy and make monetary policy “as accommodative as possible.”

Questioned on the state of the Japanese economy, Mussa gave an upbeat response, asserting that business investment had turned around and “the Japanese economy is on the path to recovery.”

“The worry,” he continued, “is that if it stumbles again then confidence is very fragile and there is a lack ... of policy tools to deal with another downward movement in the economy. So, it is particularly important at this stage of the Japanese economy, given the weakness we have seen in the decade of the 1990s, to get the recovery moving on a self-sustaining basis.”

But it is not just the Japanese economy that could be described as “fragile.” Behind the optimistic predictions of increased global economic growth, the IMF report itself points to the following situation: the world's biggest economy, the United States, expanding at an unsustainable rate as a result of stock market and asset speculation, is heading for a financial crisis; while the second largest economy, Japan, is still experiencing economic stagnation resulting from the collapse of the previous asset bubble 10 years ago.