World economy moving towards recession

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There is growing evidence not only of a US recession but that the world economy as a whole has begun a major slowdown, if not an outright contraction.

In the US, the latest figures from the international outplacement firm Challenger, Gray & Christmas, released on Monday, show that there were 101,731 layoffs in February. While this was down from the record monthly high of 142,208 in January, it was almost three times the 35,415 job cuts announced in the same month a year ago.

Job cuts since the beginning of December are 377,652 compared to 130,752 in the same period a year ago. According to the firm's chief executive John Challenger: “Even during the heavy 1990s corporate downsizing, we did not see monthly figures like this.”

The chief economist at the investment firm Morgan Stanley Dean Witter (MSDW), Stephen Roach, considers that the global economy has probably entered recession.

“Fully 30 percent of the world—the United States and Japan—already is in recession,” he noted in a comment published on February 26. “The real-time data continue to point to an unrelenting carnage on the earnings front that has triggered sharp cutbacks in IT-led capital spending and employment. The unrelenting plunge of consumer confidence only confirms the impact of such cost-cutting initiatives on the broader public. It's hard to dismiss this as just a temporary inventory correction that will quickly give way to everyone's favourite cyclical scenario—the V-shaped recovery.”

In a comment published on March 2, Roach warned that it was still early days as far as layoffs and cuts in capital spending were concerned. “Business fixed investment seems likely to decline for at least another couple of quarters, doubling the duration of the downturn that began in the final period of 2000. If the recession turns out to be deeper, or longer, than we are currently forecasting, capital and labour adjustments will only intensify. In my view, that's certainly the risk as this recessionary dynamic continues to unfold.”

The “conventional wisdom” in the US is that the Federal Reserve Board will be able, if not to prevent a recession, then at least to lessen its impact by further interest rate cuts. As the *Financial Times* noted in a recent comment, almost all analysts and investors are united in the belief that the Fed holds the key, and that, as in all business cycles since the war, “judicious exercise of monetary policy will allow a recovery to take place.”

But doubts are now starting to be cast on this soothing scenario. As the *Financial Times* put it: “But what if this near-universal faith in the power of the central bank to stimulate demand proves misplaced? What if there is something different about this turn of the century economic cycle that may limit the ability of monetary policy to produce the desired response?”

It went on to point out that all previous post-war recessions had been preceded by a period of rising inflation to which the Fed had responded by lifting interest rates, thereby triggering the downturn. But this was not the case in the present situation.

“Instead of a familiar demand-side price inflation forcing a Fed response and causing a recession, the current weakness began as a result of over-accumulation of supply, fuelled by the rise in business investment of the 1990s. Real productivity-enhancing investments in technology prompted companies to invest in far more capacity than could be required, even at faster rates of growth. It is this process, rather than a crushing of inflationary pressures, that is unwinding in the shape of a steep fall in stock prices and a sharp retrenchment in business investment.”

The problem for the Fed in such a situation is that attempts to stimulate demand through interest rate cuts is rather like “pushing on a piece of string”—something financial authorities in Japan have been experiencing for the past decade.

There the economy, after 10 years of virtually no growth, following the collapse of the financial bubble of the early 1990s, is about to record another recession, defined as two successive quarters of negative growth. The 0.6 percent contraction recorded in the September quarter of last year is almost certain to be repeated when the figures for December are published.

Economics minister Taro Aso said economic growth had “stalled” while finance minister Kiichi Miyazawa warned there were considerable “downside risks” as the Japanese government announced it was preparing another economic stimulus package, the details of which will be announced later this week.

Whatever the measures implemented, they are not expected to be any more successful than the series of stimulus packages introduced over the past decade. Moreover, the government's room for manoeuvre is narrowing. With interest rates already close to zero, further cuts will have no impact, and its ability to keep on spending is constrained by the mounting public debt, which now stands at more than 130 percent of gross domestic product—the highest for any major industrial nation.

Japan may continue to stagger on through continued government measures but for how long is another question. In an editorial last Friday, the *Financial Times*, for the umpteenth time, lambasted the government over its refusal to “accept the painful consequences of closing defunct businesses or insolvent banks.”

The economy had only been kept above water with “huge fiscal injections” but it was “not difficult to imagine that this latest cycle of economic weakening could be the one that sends Japan into deep recession” and acts as the trigger for “long-postponed” corporate bankruptcies.

Europe has enjoyed economic growth in the recent period, but signs of a slowdown are emerging there as well. Goldman Sachs said it expected euro zone growth this year to be 2.6 percent, down from the 3.4 percent recorded last year. German chancellor Gerhard Schroeder says he expects the “extraordinarily good” growth of 2000 to continue, but the country's economic indicators are pointing in the opposite direction.

Official figures show that the economy had virtually stalled by the end of last year with expansion in the fourth quarter at 0.2 percent, following third quarter growth of only 0.3 percent.

The economies of East Asia face problems on two sides. The slowdown in the United States is bringing cuts in export markets at the same time as Japan, the economic mainstay of the region, is going into another recession.

One of the sharpest expressions of the turnaround in the world economy can be seen in Australia. Only last November, the government was revising upwards its economic growth forecast. This week, however, financial markets are anxiously awaiting publication of national accounts data that is expected to show low growth in the December quarter, and possibly a contraction.

In a front-page report published on March 3, the *Australian* declared: “Australia has slipped to the edge of recession, with a stunning retreat in business and housing investment pointing to the first contraction in the economy since 1991. The Treasury Department is believed to have warned the Howard government that official figures ... increase the risk that the economy went backwards in the final three months of 2000.”

The main falls were in business capital expenditure, down 5.2 percent, home building 12.8 percent, and exports 2.2 percent. Retail sales rose 1.8 percent, but this followed a 3.3 percent decline in the September quarter. On Monday a survey on job advertisements conducted by the ANZ bank showed a 10 percent decline—the biggest since the 1991 recession. The bank's chief economist Saul Eslake said firms were cutting staff because “the economy is weakening and profits are under pressure.”

It is ten years since the last US and global slowdown. In that period the economic situation has been further complicated by the closer integration of financial markets. So-called “contagion” saw the rapid spread of the financial crisis in Asia to Russia and then onto Wall Street with the collapse of the billion dollar hedge fund, Long Term Capital Management, in September 1998. The crisis was brought under control through the intervention of the Federal Reserve Board, and the recessionary tendencies in Asia were modified by the continued expansion of the US economy.

But any “emerging market” financial crisis, erupting say in Turkey, or Argentina or south-east Asia, takes place under different conditions today.

As MSDW economist Roach noted: “In 1997-98, emerging market risks were ultimately tempered by the American boom. The US economy powered ahead at a 4.4 percent average annual rate during those two years, and its imports surged by about 13 percent over that period. As a result, the wrenching crisis in the developing world of 2-3 years ago was backstopped by the world's importer of first and last resort. ... Not this time. In 2001, any emerging-market risks will be exacerbated by a US economy in recession.”

According to his analysis, the lack of powerful US growth “could turn a relatively minor emerging-market crisis into a much larger one. The American boom tempered lingering systemic risk in the developing world. The American recession could well unmask that same systemic risk.”

In other words, a combination of recession and financial crises could create a far more serious situation than the proponents of the V-shaped recovery envisage.