IMF report points to global slowdown and potential disruption

Nick Beams
28 April 2001

Six months ago when the International Monetary Fund issued its half-yearly report, the world, in the words of one its leading officials, appeared to be a much “safer place.” Growth was continuing in the United States, the European economy was expanding, East Asia was recovering from the crisis of 1997-98 and there were even signs that a Japanese “recovery” might finally get under way.

The picture presented in the latest World Economic Outlook released on Thursday is very different. Apart from cutting the world growth forecast by 1 percentage point, the main feature of the report is the uncertainty over the future course of the global economy and the warnings that, notwithstanding the hopes that the situation could quickly turn around, it could also worsen quite rapidly.

In his press conference releasing the report, IMF director of research Michael Mussa pointed out that last September in Prague world growth for 2001 was predicted to be 4.2 percent. This has been revised down to 3.2 percent. It is clear, he said, that “global growth is slowing more than was anticipated, or is desirable.”

“For the United States, which has been the mainstay of global expansion in the past decade, growth this year is forecast to be only 1.5 percent, down from almost 5 percent last year and from an earlier forecast of over 3 percent for this year.”

The projection for the year 2002 has been reduced to 2.5 percent, at least one percentage point below the estimated potential growth rate for the US economy.

In the euro-zone, the IMF estimates the growth rate will be 2.4 percent, a full percentage below what it forecast last September.

Mussa said the situation in Japan was “even more worrying” with growth for this year forecast to be barely over 0.5 percent and growth for next year expected to reach only 1.5 percent.

Asia will be hit by the slowdown in North America and Japan and by the global downturn in telecommunications and high technology with estimates for growth coming in at between 1 and 3 percentage points less than six months ago.

Mussa, however, did not confine his remarks to the details of the report but delivered a stinging rebuke to the European Central Bank and its refusal to cut interest rates, following rate cuts in the US and Japan.

After noting that the euro area was not contributing sufficiently to world economic demand, Mussa continued: “In a period when general economic slowdown is the main problem and when inflation is not likely to be a continuing threat, the euro area, the second largest economic area in the world, needs to become part of the solution rather than part of the problem of slowing down world growth.”

Mussa took the opportunity to deliver another broadside when taking questions from journalists on the briefing.

Asked to comment on whether calls on the ECB to cut interest rates by the managing director of the IMF and the US treasury secretary could be regarded as “interference” Mussa replied: “Here in the IMF we don't call that interference. We call it surveillance. And it is mandated by the Articles of Agreement.”

In delivering its pronouncements, and particularly in setting out policy prescriptions for countries that are considered not to have measured up, the IMF strives to create the impression that it is fully in command of the situation, with a deep understanding of the processes taking place in the global economy. But it seems the impression is starting to wear a little thin—even among financial journalists who can usually be relied upon to echo its analysis without asking too many questions.

As one journalist pointedly commented: “Mr Mussa, it seems that yourself and Wall Street and every economist has been caught by surprise by this slowdown. In the last WEO you said the prospects were the best in a decade. Now you say we'll avoid recession. Given the situation is so fluid, how can you be so certain that we won't actually dip into a US recession and possibly a global recession?”

Mussa replied that there was “no certainty in this business” and offered the reassurance that policy in most countries, which had policy flexibility, had been adjusted “promptly and reasonably aggressively to the threat that things might be even somewhat worse than we have allowed for in the baseline.”

The WEO report itself claims there is a “reasonable prospect that the slowdown will be short-lived” but warns that “the outlook remains subject to considerable uncertainty and a deeper and more prolonged downturn is clearly possible.”

So far, it notes, the effects of the global slowdown have been most visible in countries which have close trade ties with the US, including Canada, Mexico, and East Asia. The outlook for the rest of the year “will depend on how deep and prolonged the slowdown in the United States proves to be”—an issue which “remains subject to considerable uncertainty.”

The WEO says its baseline scenario is that the US economy will pick up in the second half of the year, growth will remain strong in Europe, while recovery in the Japanese economy will resume in 2002. But it adds that while this scenario is “plausible” it is far from “assured” and the “risks of a less favourable outcome are clearly significant.”

One of those risks, it states, is that the “virtuous ‘new economy' circle of rising productivity, rising stock prices, increased access to funding, and rising technology investment that contributed to the strong growth in the 1990s could go into reverse.”

Even this is a somewhat optimistic assessment, given that most observers of the US economy have concluded that, whatever the immediate outcome of the present downturn, overcapacity in all sections of industry—and above all in high-tech investment—means that there is no prospect of the boom of the latter 1990s returning.

The report notes that if the slowdown does prove to be deeper and more prolonged than anticipated “this would pose several interlinked risks for the global outlook that would significantly increase the chance of a more synchronised and self-reinforcing downturn developing.”

Among those risks is the possibility that what the report calls “apparent misalignments among the major currencies” could “unwind in a disorderly fashion.” It points out that current account deficits of the size presently experienced by the US—more than $430 billion, equivalent to around 4.5 percent of gross domestic product—have not been sustained for long and that “adjustment is generally accompanied by a significant depreciation [of the currency].”

If there were increased economic growth in Europe and Japan, then it would be possible to reduce the US imbalances in a “relatively manageable and nondisruptive fashion.”

“However, in an environment where US growth slows sharply, the portfolio and investment flows that have been directly financing the US current account deficit could adjust more abruptly.” In other words, there could be a rapid movement of capital out of the US and a sharp fall in the value of the dollar.

“This would heighten the risk of a more rapid and disorderly adjustment, possibly accompanied by financial market turbulence in both mature and emerging markets. Large swings in exchange rates could also limit the room for policy manoeuvre.”

That is to say, according to the IMF's latest forecasts, there could arise a situation in which the US dollar starts to fall and financial markets are hit by a crisis, under conditions of a deepening slump. The fact that such a possibility is even being canvassed is a measure of how far and how fast the world economic situation has moved in the past six months.