Bank report points to growing difficulties for world economy

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The sharp drop in US growth rates since midway through last year has given rise to concerns at the Bank for International Settlements (BIS) that something more than a short-lived downturn in the business cycle is at work and that the world economy as a whole could be entering troubled times.

While such a prospect is not explicitly drawn out in the annual report of the BIS, released on Monday, it is certainly implied in a number of its key sections.

Delivering the report, BIS general manager Andrew Crockett warned that the US economy faced a “hard landing” unless growth rates began to pick up in the rest of the world. He acknowledged that while there had been a sustained increase in US productivity it was “important not to exaggerate on the productivity side.” The BIS report pointed to a number of imbalances in the US economy, including the current account deficit, high private debt and a historically low savings ratio.

According to Crockett, the best scenario would be if economic growth increased in the rest of the world and there was a gradual depreciation of the US dollar. “But if these things do not happen,” he continued, “the risk remains of more disruption, and that is something we have always warned about.”

The report noted that while the slowing of the US economy had been expected, its suddenness was “remarkable” for a number of reasons. It seemed to mark the end, or at least a significant pause, in the decade-long global expansion in which the US had played such a decisive role. Furthermore, it was accompanied by an “interruption” of recovery in Japan, a slowdown in “emerging markets” and a certain slowing of the European economy. “And it profoundly disappointed those who hoped that a 'new economy' based on information technology had made both inventory cycles and sharp fluctuations in investment spending a thing of the past.”

When the slowdown developed, the “usual suspects,” including oil prices rises and increases in short term interest rates, were rounded up to explain the turn in global events, but at the same time “there were concerns that less usual forces were at play”. This is a reference to concerns that while slowdowns in the post-war period have been associated with the tightening of interest rates to curb inflation, the present downturn may be taking the form of business cycles prior to World War I, which were the outcome of a rapid build-up of capital investment followed by a bust.

After noting that the downturn in the US had spread rapidly to other countries and regions, the report said that “near-term prospects for the global economy are particularly uncertain at this juncture.”

“One structural, and crucial, factor is the nature of productivity growth in the United States. If the surge in labour productivity growth over the past few years reflects structural improvements which can spread to other countries and buoy future profits, there is a greater chance that the slowdown will be mild and short-lived.”

In other words, according to the BIS analysis, the pre-condition for the world economy to avoid a protracted fall in growth, if not a recession, is for at least one region to experience the kind of high-tech investment boom seen in the United State from 1995 to the middle of last year. Given the financial crisis in Japan and the slowdown in Europe such a prospect is not even on the horizon.

With one of its responsibilities to oversee the international financial system, the BIS, sometimes referred to as the central bankers' bank, spent some time in its report examining the implications of the changes in global financial markets flowing from the sweeping deregulation of the past fifteen years.

The report claimed that while the liberalisation of financial systems had improved the allocation of resources “liberalisation has arguably increased the scope for pronounced financial cycles" contributing to the amplification of cycles in the macroeconomy ending all too often in the past in "costly banking system crises."

"At the root of these cycles typically lies a wave of optimism generated by favourable developments in the real economy. This optimism contributes to the underestimation of risk, overextension of credit, excessive increases in asset prices, overinvestment in physical capital and, in some cases, overly buoyant consumer expenditures. Eventually, when more realistic expectations emerge, the imbalances built up in the boom need to be unwound, sometimes causing significant disruption to both the financial system and the real economy."

Addressing such problems, the report noted, "poses an exceedingly difficult, yet increasingly important challenge for supervisory authorities and central banks." The scope for financial cycles to inflict economic damage was much less than in the days when financial systems were heavily regulated.

In its concluding section, suggestively titled "The recent past as prologue?" the BIS points out that whatever the analysis of the present situation it is clear that the interconnected character of the global economy means that problems in one region will be transmitted rapidly through the system. Not only have trade and investment links grown, along with international mergers, capital markets have provided further global linkages.

"There has been a growing tendency for bond rates, stock prices, credit spreads and risk premia in various markets to show similar movements, with the direction commonly set in the United States. Moreover, these connections also increase the likelihood that any failure in the functioning of one market will quickly be manifested elsewhere. Such linkages are clearly important in themselves, but they also imply that the diversification of risk in capital markets could become progressively more difficult. And, as was seen at the time of the [Long Term Capital Management] crisis [in September-October 1998], never more so than when the markets are under stress."

In contrast to some of the more optimistic assessments on the state of the international economy and the new vistas opened by financial globalisation, the BIS report emphasised the importance of international co-operation between the major capitalist powers.

"There is ... a growing risk that, if the less palatable implications of globalisation are not effectively managed, developments could tilt in the opposite direction. Excessive reliance on regional solutions is one possibility. Recourse to outright protectionism, which is still thought to be a viable option by many, is another. Should the eruption of long-standing latent trade frictions or worsening economic circumstances bring such tendencies to the surface, they will have to be vigorously resisted if the economic gains of the last few decades are not to be jeopardised."

Since the BIS report was prepared a number of indicators have pointed to a worsening of global economic conditions.

The Japanese economy seems certain to fall back into recession following a 0.2 percent contraction for the first quarter of this year.

In the United States, productivity—hailed as the basis of the "new economy"—has suffered its biggest fall in eight years, declining at an annual rate of 1.2 percent for the first three months of this year. The Blue Chip survey of economists released last Sunday showed that while most believed the US would avoid an outright recession—two consecutive quarters of negative growth—the economy was nevertheless "skating on thin ice."

In Europe, an index of future trends prepared for the *Financial Times* showed growth coming in under the rate of 2 to 2.5 percent projected by the European Central Bank. And in Paris, the Organisation of Economic Cooperation and Development, representing the major capitalist economies, has reported that its composite index indicating future economic trends fell by 0.6 percent in April after the 0.5 percent decline the previous month. A Reuters report noted that the series is considered a good guide to trends six months or more ahead and "the numbers indicate that the global economy continues to cool with no rebound yet in sight."