Stock markets rise but global growth forecasts revised down

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There is a growing divergence between financial markets and the increasingly gloomy forecasts about the state of the world economy. In the past two months, the Dow Jones index has risen by 20 percent, wiping out the losses sustained on Wall Street in the aftermath of September 11. But this rise is not being matched by a rebound in the real economy, with forecasts for both US and global growth being revised down, amid warnings that the indebtedness of the Japanese banking system is approaching a disaster.

Last week the International Monetary Fund issued its revised forecast for the world economy, predicting growth of just 2.4 percent for both this year and next, half the growth rate of 4.7 percent in 2000. These estimates were lower than the 2.6 percent growth for this year and 3.5 percent expansion it forecast in its annual report issued in October but compiled too late to take account of the impact of the September 11 attacks.

The figures could be revised down again. IMF managing director Horst Koehler said there was an "extraordinary degree of uncertainty" in the aftermath of the September 11 events which made "forecasting based on previous experience something like trying to read the tea leaves."

According to the IMF, the US economy will grow by just 1.1 percent this year and 0.7 percent next year, down from the October predictions of 1.3 percent and 2.2 percent respectively. Growth in the European Union was forecast at 1.7 percent for 2001 and 1.4 percent for 2002 compared with the earlier forecast of 1.8 percent and 2.2 percent respectively. The IMF predicts that Japan will be in an outright recession both this year and next with contractions of 0.9 percent in 2001 and 1.3 percent in 2002.

The latest predictions form a stark contrast with those of a year ago. Then the IMF pointed to the "continued strength of the US economy, a robust expansion in Europe and a nascent—albeit fragile—recovery in Japan." Growth for this year was predicted to be 4.2 percent.

The downward revision saw Koehler warn financial markets that they may not be taking account of all the risks. "Equity markets," he said, "appear to be pricing in a relatively rapid recovery. However, it remains unclear whether [they] have fully priced in the deterioration in corporate credit quality and earnings prospects that has occurred thus far."

The downward revision by the IMF has been followed by the Organisation for Economic Co-operation and Development. In its latest forecast, covering the world's 30 largest economies issued this week, the OECD warned that global growth would reach only 1 percent in 2002. The US was "already in recession" and was expected to expand by only 0.7 percent next year. But as one comment in the *Australian Financial Review* noted, even that might be too optimistic. Growth of 0.7 percent for the US and 1 percent for the OECD area as a whole would mean that the US would have to resume growth in the first half of next year—signifying a relatively mild recession.

Like the IMF, the OECD forecast that "the Japanese economy appears set to remain in recession through 2002, at least."

The rebound on US share markets seems to be the result of the belief that the combination of interest rate cuts and fiscal stimulus will see the American economy rapidly increase its growth rate—the so-called V-shaped recovery. But some observers are casting doubt on this optimistic scenario.

Morgan Stanley has again revised down its forecast for global growth predicting a rate of just 1.7 percent for both this year and next. According to its chief economist Stephen Roach: "If this forecast comes to pass, it would mark the weakest consecutive two years of global growth in recorded post-World World II history."

Another to cast doubt on a rapid recovery is this year's

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Nobel Prize winner for economics, Joseph Stiglitz. Writing in the *Washington Post* on November 11, he warned that the Republican-backed stimulus package—based largely on massive tax handouts to corporations and the wealthy—will do little to boost the economy and may even make matters worse.

Even more worrying than the situation in the US, he wrote, is the threat to the world economy. “Already we see inklings of the downward spiral that was part of the Great Depression of 1929: Recession in Japan and parts of East Asia and bare growth in Europe are contributing to and aggravating the US downturn.”

A report issued last month by the Levy Economics Institute points out that the recession in the US is different from others in the recent past because of “large structural imbalances” in the American economy.

According to the report’s authors, economists Wynne Godley and Alex Izurieta: “The United States should now be prepared for one of the deepest and most intractable recessions of the post-World War II period, with no natural process of recovery in sight unless a large and complex orientation of policy occurs both here and in the rest of the world. The grounds for reaching this sombre conclusion are that very large structural imbalances, with unique characteristics, have been allowed to develop. These imbalances were always bound to unravel, and it now looks as though the unraveling is well under way.”

Among those imbalances was the fall in the private sector financial balance (total disposable income less expenditure), which reached the “previously unheard of” level of minus 6 percent last year. They noted that this excess of expenditure over income, requiring growing injections of credit, was inherently unsustainable and made the private sector “increasingly vulnerable to negative shocks such as a downturn in income, employment, asset prices, profits, or investment.”

While concerns mount over the state of the US and world economy, the financial position in Japan is going from bad to worse with the emergence of deflation threatening to further undermine the position of banks and other financial institutions.

An article by the *Financial Times* global economics commentator Martin Wolf entitled “Japan on the brink” published on November 14 described the experiences since the collapse of the Japanese “bubble economy” a decade ago as an “awful warning” and one that the US Federal Reserve has had in mind during the 10 interest rate cuts so far this year.

“The most significant fact about Japan,” Wolf wrote, “is that prices are falling. The figures are less startling than those for the Great Depression in the US, when consumer prices fell by a quarter. Nevertheless, the broadest measure of the price level, the deflator for gross domestic product, has fallen by 6 percent since its peak in 1993. The rate of decline is also accelerating: in the year to the second quarter of 2001, the deflator declined by 2.2 percent. In the second quarter it declined at an annualised rate of 7.4 percent.”

The most significant effect of falling prices is that it raises the real level of interest and increases the debt burden on both the private and public sector to the point where, if continued, it becomes unsustainable. Over the past 10 years, the ratio of gross public debt to GDP in Japan has increased from 61 percent to 131 percent, the highest level for any OECD country. If debt levels keep rising at this rate, at a certain point, not too far into the future, confidence will collapse leading to soaring interest rates, high inflation and outright default.

In an editorial comment on November 15, the *Financial Times* noted that over the past decade the “outside world’s attitude to the Japanese economy has moved from awe to puzzlement and then to indifference. Now it should move to anxiety. At a time of gathering global distress, the plight of the world’s second largest economy and creditor is set to become worse.”

It warned that if prices continue to fall, real interest rates would become “devastatingly high.” In an economy “already burdened with vast post-bubble debt and a heavy burden of non-performing loans, the result would be an ever-widening spiral of mass bankruptcy, financial contraction and deepening recession.” The editorial insisted that the key task facing the Bank of Japan was to halt the fall in prices and that its failure to do was “simply a calamity.”

Under conditions where Japanese sources have financed a large portion of the US international debt, an implosion on the Tokyo financial markets, leading to the calling in of funds from the rest of the world, would have major consequences for the world economy. Insofar as the rapid rise in US financial markets is based on an assessment that the situation will soon return to “normal”, it could be somewhat premature.

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