US economic recovery predicted but "imbalances" worsen

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The International Monetary Fund is predicting the lightest US recession on record and a significant pick up in the world economy by the end of this year, according to the draft of its World Economic Outlook leaked last week.

The draft said the US economy would grow by 1.4 percent this year, up from the 0.7 percent expansion the IMF predicted last December, with growth accelerating to 3.8 percent by 2003. While forecasting global growth of only 2.5 percent this year—a rate considered by many observers to signify a recession—the IMF said there would significant expansion next year.

"The risks for the global economy are 'more balanced' than they were a few months ago," the draft report said. "There are good reasons to expect the global economy to pick up."

The IMF's upbeat forecasts are in line with the most recent assessment by the US Federal Reserve Board, which has indicated that its cycle of interest rate cuts are over and that the American economy is "expanding at a significant pace".

But the Fed's confidence in a rapid upturn does not seem to be matched in major US corporations. According to a report in the March 25 edition of *BusinessWeek*, "CEOs around the country remain decidedly cautious, even downright gloomy, about the state of the US economy" particularly in manufacturing. It pointed out that a survey released by the National Association of Manufacturers on March 11 showed that three-quarters of corporate executives expected gross domestic product to expand no more than 2 percent in the first half of the year.

"For growth to be sustainable, corporations will need to loosen their purse strings in the coming year and expand capital spending and hiring. But in manufacturing, the capacity utilization rate is about 73 percent, the lowest since 1983. So companies can handle a significant uptick in demand before they need to think about adding capacity."

Predictions of a rise of 17 percent in profits, the report noted, may not induce increased investment spending because the rise is from low levels and, even if the predictions were met, profits would only return to 1999 levels.

Aside from the seeming dichotomy between macroeconomic predictions and the outlook of business, there are other indications that a return to the economic growth levels of the 1990s is not in prospect either for the US or world economy. Economic observers with a longer-term view point to the fact that the major structural imbalances that emerged in the latter half of the 1990s have not been resolved and may be worsening.

These imbalances centre on the widening US balance of payments gap and the absence of sustained growth in the rest of the world—in particular Europe and Japan—needed to sustain global economic expansion. The origins of this disequilibrium are to be found in economic processes going back more than a decade.

In the first half of the 1990s, world economic growth was sustained by the rapid expansion in East Asia, fueled by the inflow of funds from the major capitalist countries. It is estimated that the so-called "Asian economic miracle" contributed about half the increase in world growth during the first half of the 1990s, while the major capitalist economies experienced a so-called "jobless recovery".

Then, with an increase in the value of the US dollar from 1995 onwards, changing financial conditions boosted growth in the American economy. Capital shifted out of East Asia into US markets, attracted in part by the high-tech boom, and created the conditions for the stock market and financial bubble of the latter half of the 1990s. As a result, growth in the US economy was responsible for more than 40 percent of the increase in global demand.

But this created an inherently unstable situation. The world economy as a whole has become increasingly dependent on the US market, while the US economy has relied on an inflow of capital from the rest of the world to finance its balance of payments deficit.

At the beginning of the 1990s, when the last global recession ended, the US current account was roughly in balance. Today, however, the US balance of payments gap is equivalent to more than 4 percent of GDP, requiring a capital inflow of $1 billion a day to finance it. And if the US growth rate increases to the level necessary to ensure world economic expansion, this inflow will have to rise still further. This means that at a certain point, the deficit may become so large that it brings about a fall in the value of the US dollar, creating the conditions for a rapid outflow of capital.

In a comment published on February 26 under the title “An unsustainable black hole”, *Financial Times* columnist Martin Wolf noted that while the Federal Reserve Board had been pursuing a policy based on the principle “look after the short run and the long run will look after itself,” the long run can “bite back”.

He pointed out that the Fed’s policy for a recovery, far from correcting the imbalances in the US economy—rising debt and the balance of payments deficit—depended on their continuation. This could bring about severe financial problems in the future.

“The US, it is hoped, is now on its way to a demand-led recovery. The current account deficit is therefore likely to widen. Goldman Sachs forecasts a rise in the US current account deficit from about $420 billion last year (4.1 percent of GDP) to $730 billion (5.9 percent of GDP) by 2006.”

At this rate of increase, according to Wolf, the net international debt of the US, estimated to be $2.6 trillion at the end of 2001 and representing 20 percent of GDP, would rise to $5.8 trillion in five years, representing 46 percent of US GDP and about 15 percent of the rest of the world’s GDP.

“Even that is not the end of the story,” he continued. “In a study published in 1999, Catherine Mann, formerly on the staff of the Federal Reserve Board, argued that net US liabilities could reach 64 percent of GDP by 2010. This trend cannot last. The difficulty is knowing when and how it will end. But the longer the process continues, the more painful that ending is likely to be.”

Morgan Stanley chief economist Stephen Roach is another to warn that, with the US economy facing an “unsustainable external imbalance” amounting to more than 4 percent of GDP, world economic growth cannot be maintained through an expansion of the US economy. As he noted in a comment published on March 4: “Never in recorded history has the world’s growth engine attempted to jump-start the global economy with such a massive balance of payments deficit. Indeed, the real risk is that this imbalance could get considerably worse if the world stays the course—with the US current account deficit rising to 6 percent in 2003, and considerably higher in the years beyond.”

Roach added that the US would have increasing difficulty in financing its deficit at present exchange rates. This is because there has been a shift in the financial inflows from direct investment, in particular through mergers and acquisitions, into corporate and Treasury bonds. In 2001, net bond inflows from foreign investors covered 90 percent of America’s current account deficit.

The implication of this shift is that the capital inflows used to finance the payments deficit have become much more volatile. Consequently, uncertainty about US equity and financial markets could bring a rapid outflow, leading in turn to a fall in the value of the dollar, prompting a further outflow.

The latest “flow of funds” analysis undertaken by Jane D’Arista of the Financial Markets Center notes that “continuing debt growth provided ample momentum for the modest, if unexpected, resumption of economic growth in the fourth quarter of 2001”.

While providing a short-term boost, the growth of debt is a destabilising factor in the long term. “America,” D’Arista noted, “has become increasingly dependent on external savings to maintain growth. Foreign investors’ purchases of credit market instruments have expanded the domestic credit supply, providing incentives for US residents to borrow and disincentives for saving.

“The flip-side of this dynamic is increased global reliance on US demand for imports, which generates the dollars that foreign investors use to add to their holdings of US financial assets. The burgeoning current account deficit produced by this dynamic ... has become the leading indicator [of] an unbalanced and vulnerable US economy.”

According to her analysis, rising debt burdens and the prospect of diminishing foreign inflows threaten to “unravel the growth formula of the 1990s”.