IMF cuts global economic growth forecast

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The International Monetary Fund (IMF) has painted a gloomy picture of the global economy in its latest *World Economic Outlook* report published last week, cutting its forecast for world growth from the rate of 3.7 percent it predicted last September to 3.2 percent.

IMF chief economist Kenneth Rogoff said growth would come back to a more normal level of 4.1 percent in 2004 but warned that optimism could be misplaced because of several risk factors, including the continuing impact of the bursting of the stock market bubble and fears that a bubble could develop in the US housing market.

At a press conference on the report, IMF managing director Horst Koehler said the baseline scenario was for economic recovery asserting itself in the second half of 2003. However, an examination of the report itself makes clear that the key sectors of the world economy—the United States, Europe and Japan—face growing problems with the "balance of risks" on the downside.

The IMF lowered its growth rate prediction for the US from 2.6 percent to 2.1 percent, its European rate from 2.3 percent to 1.1 percent and its Japan rate from 1.1 percent to 0.8 percent.

It said that the US economy in the second half of 2002 had "failed to sustain the momentum" of the first half, with growth in the fourth quarter "turning very low." Household spending, it noted, had provided the chief prop for the US economy in the most recent period but would not be able to continue to do so. The potential boost for spending from mortgage refinancing had "probably run its course" while "auto discounting is a thing of the past". Consumer confidence and the labour market were described as "soft," while firms faced "lacklustre sales."

Apart from the war on Iraq, a key risk to the economy related to whether "bubble-period excesses" had fully worked themselves out of the economy. It seems that they have not. According to the IMF, there is significant overcapacity "throughout the US economy, including in the IT, airline, automobile, and energy sectors."

Another risk was the growing debt-financed US balance of payments deficit. This could "engender an abrupt drop in the dollar that could in turn trigger upward pressure on interest rates and a disruption of recoveries both in the United States and abroad."

On the European economy, the report said that growth "continued to disappoint in the second half of the year, especially in Germany, and prospects remain lacklustre." The outlook for investment in Europe, which has contracted continuously since mid-2002, was somewhat "tentative" in view of spare capacity, weak business confidence and excess corporate debt. There could also be financial strains due to losses by life insurers and pension funds.

The IMF was particularly downbeat on the Germany economy, which accounts for around 28 percent of European gross domestic product. "Germany's stagnation," it said, "remains a particular concern, the more so given the dearth of evidence of a turnaround with industrial production, business confidence, and retail sales continuing to slump, and the jobless rate at a three-year high."

It warned that the risks of deflation in Germany were greater than elsewhere in the industrial world, outside of Japan. The danger is that there could be an interaction between "bank and firm weakness". Under conditions where bank profits are weak while corporate insolvencies are surging, and falling property and equity prices erode capital resources, banks' "risk aversion" may increase, leading to cuts in lending.

The report pointed to a decline in credit growth that has already taken place in Germany. "While most analysts believe that these problems are not systemic at present, they could nevertheless grow over time, particularly if economic recovery is delayed and the deterioration in corporate balance sheets and profitability are not reversed.”

The IMF gave the umpteenth warning of the need to take urgent action in Japan to re-establish inflation. Prices in Japan, it noted, have now fallen for four consecutive years, which is unprecedented for industrial countries in the past half century.

“Persistent deflation is dangerous because it limits monetary policy flexibility, increases real debt burdens, and provides an incentive to delay spending, which reinforces deflation, thus risking a deflationary spiral.”

It warned that the most significant risk in Japan “remains a worsening of banking problems, possibly promoted by further declines in equity prices or mismanaged efforts to strengthen banks.” Such mismanagement could involve forcing banks to recognise so-called “problem loans” and thereby imposing significant losses without giving them a compensating boost in their capital. “A related risk,” the report continued, “is credit crunch, as some banks curtail lending in attempts to improve their capital adequacy ratios.”

Given the growing problems confronting the world economy, Horst Koehler emphasised the need to restore confidence to consumers and investors. “In a world of economic and political interdependence, this requires the credible demonstration of international cooperation.” The “need of the hour”, he emphasised, is “cooperation.”

But that could be difficult to obtain following the conflicts among the major powers over the US-led war against Iraq and the continuing differences over post-war reconstruction, the role of the United Nations, the control of oil revenues, and debt forgiveness for Iraq.