Global recovery could be short lived

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The Organisation for Economic Cooperation and Development (OECD) has painted a rosy scenario for the world economy. According to its semi-annual Economic Outlook issued last week, the combined gross domestic product (GDP) of its 30-member states will increase at its fastest rate in four years during 2004.

The report said that the global economic recovery was now "strong and sustainable" with investment, especially on information technology, expected to increase. It forecast an increase of 3.4 percent in real GDP in the OECD area this year, up from 2.2 percent in 2003 and a significant increase from the 3 percent growth rate predicted last November.

However, there is a striking contrast between the OECD forecasts and the instability in financial markets. Last week Wall Street hit its lowest point for the year, the Japanese stock market has recently experienced one of its largest single-day falls in the last 20 years and bond prices in so-called "emerging markets" such as Turkey, Russia and Brazil have fallen sharply in recent weeks. According to the *Economist*, the Morgan Stanley index of emerging markets has fallen by 17 percent from its peak and the Argentine and Brazilian stock markets are both down by 30 percent from their recent highs.

The main reason for the financial market turbulence is the expectation that the US Federal Reserve must soon start increasing the federal funds rate from its current 46-year low of 1 percent and the fear that rising rates could start a plunge in bond markets. At its meeting earlier this month, the Fed decided to keep rates unchanged but indicated that its "[monetary] policy accommodation can be removed at a pace that is likely to be measured."

This was intended to let financial markets know that rate rises are coming but that there will not be a repeat of the experience 10 years ago when the Fed doubled the rate in less than a year, sending bond markets into a tailspin and leading to a financial crisis in Mexico. But there are fears that with rates having been kept so low—with inflation at around 1.7 percent the base rate of 1 percent is negative in real terms—increases may now come faster than expected. According to one estimate, a neutral rate, one that neither stimulated nor depressed the economy, would probably be about 5 percent.

The fear in financial markets is that even a small increase in rates will have a major impact on the so-called "carry trade", in which financial speculators take advantage of low short-term rates in the US to invest in riskier longer-term ventures elsewhere. According to a comment published in the May 10 edition of the *Financial Times*, while an increase in US rates to 1.25 or 1.5 percent would "probably not derail the global recovery", it would "make the carry trade a much more risky bet."

At the same time, the Fed's decision to keep interest rates at an historic low has come under criticism from economists and commentators who believe that by doing so it has adopted a policy of fueling American economic growth through the creation of financial bubbles.

Commenting on the decision by the Fed not to increase rates, Larry Elliott, the economics commentator for the *Guardian*, said one explanation may be that US Fed chairman Alan Greenspan "believes the US economic recovery is far less robust than the public has been led to believe, and that withdrawing monetary stimulus could bring the house of cards down." Noting that Greenspan had solved the problems caused by the collapse of the stock market by creating two new bubbles in the housing and bond market, Elliott drew attention to some pointed comments by economist Kurt Richebacher.

According to Richebacher: "The stock market bubble of the 1920s ended with an unprecedented consumption boom, and just that has been happening since 1997, and particularly since 2001. Since then, consumer spending has accounted for 92 percent of GDP growth. Yet, to keep it rising in the face of grossly lacking income growth, the Fed has invented a policy stance that has no precedent in history: boosting home prices with artificially low interest rates in order to provide rapidly growing collateral for consumer borrowing."

This has led to a situation where the low-interest rate regime has papered over "existing maladjustments from the boom through even bigger, new bubbles and macroeconomic maladjustments, heralding much worse to come in the future."

Morgan Stanley chief economist Stephen Roach is another to place a question mark over the sustainability of the world economic recovery. In a comment published on May 10, he pointed to a "perfect storm" on the horizon threatening upwardly revised global growth expectations. The nascent recovery, he claimed, is threatened by surging oil prices, a potential China slowdown, and the onset of a Fed tightening cycle.

Roach noted that, while markets had already started to move in expectation of tightening interest rates, "the risk is that the Fed now has much greater distance to travel than most investors are willing to concede."

The "normalisation" of Fed policy by lifting interest rates from their present historic lows was a greater risk to economic growth in the US and the rest of the world than a decade ago, he wrote. This was because the "carry trade" is more significant and monetary tightening will "exacerbate the downside of the home mortgage refinancing cycle" which has been such a powerful source of the growth in consumer demand.

Roach warned that the confluence of these three essentially deflationary forces—rising oil prices, a slowing Chinese economy and increasing US interest rates—could make the current rebound in the global economy one of the shortest on record.