Global growth rates rise, but the foundations are shaky

Nick Beams
25 April 2006

The International Monetary Fund (IMF) has lifted its prediction for global economic growth by 0.6 percentage points to 4.9 percent, but repeated earlier warnings that global imbalances must be corrected lest they spark a financial crisis and recession.

The forecast and warnings were contained in the IMF's latest *World Economic Outlook* report released last week. It noted that it was the fourth year in a row that global growth would be above 4 percent, with expected additional growth in China, Russia and India accounting for two thirds of the upward revision.

While predicting that growth rates would continue to remain relatively high—the prediction for 2007 is 4.7 percent—the IMF warned that the risks were chiefly on the downside. The main dangers came from the growing balance of payments deficit of the United States, estimated to be around $800 billion or 6.5 percent of gross domestic product this year, and the corresponding surpluses of China, the East Asian economies and the oil-exporting countries.

The IMF insisted that with strong global growth the time was ripe for action to correct the imbalances, repeating a similar call it made last September. Without a co-ordinated response to correct the imbalances "there is a clear risk of a disruptive adjustment and a global recession," the report stated. "The principal challenge for global policymakers is to take advantage of the favourable conjuncture to address these vulnerabilities."

The IMF wants a reduction in the value of the US dollar and more savings in the US, coupled with increased consumption and higher currency values for China and other countries with large balance of payments surpluses. It warned that while there was a "temptation to put the issue on the back burner," action had to be undertaken or the risks of a disorderly adjustment would increase. "The longer the adjustment is delayed, the larger these exchange rate adjustments will ultimately need to be, and the greater the risk of overshooting."

The danger is that while the world economic growth is more dependent than ever on an expanding US market, that expansion is increasingly dependent on debt, financed by an inflow of funds from the rest of the world now running at more than $2 billion a day. If investors lose confidence in the American dollar and seek to place funds elsewhere this could lead to a rapid jump in interest rates, sparking a financial crisis and recession.

These warnings were underscored in remarks by both IMF economic counsellor Raghu Rajan and IMF managing director Rodrigo de Rato.

Rajan pointed to what he called a "growing implementation deficit" with "far too little being done in far too many places." He noted that as the US deficit continues to be financed easily, "the optimists, who think there is nothing to worry about, are gaining ground over the pessimists who think that an abrupt and costly adjustment is likely. But the optimists have to be right every day while the pessimists need to be right only once."

Asked about the risk of an "abrupt adjustment" of global imbalances, he said that the "risk is there and ... the longer the imbalances continue" the higher the probability of such an event.

In an indication of the rising tensions between major capitalist powers, he also warned of increasing protectionism, now dubbed economic patriotism, emerging in the form of government intervention to prevent foreign takeovers of prominent corporations.

"Economic patriotism is protectionist wine in a mislabelled new bottle and is all the more dangerous in this interconnected world. The beggar-thy-neighbour policies being contemplated by some countries in the capital account—that is, shielding large portions of their own economy from corporate takeovers while encouraging their own companies to take advantage of the continued openness of others—deserve to be roundly condemned. People tend to dismiss these as minor frictions, sand in the gears of the globalisation juggernaut. History, however, suggests there is a short distance from economic patriotism to unbridled nationalism."

Speaking to a press conference the following day, de Rato also emphasised that the IMF regarded the present global imbalances as "serious risks" to the world economy. He said arguments that global imbalances could persist forever or would dissipate of their own accord were "unrealistic". "The global economy remains vulnerable to an abrupt and disorderly adjustment of global imbalances and we all have to realise that."

Over the weekend, de Rato announced that the IMF was to initiate "multilateral surveillance" and "multilateral consultations" in an effort to address the imbalances in the world economy. The consultations would be "a process that goes beyond analysis and description of problems" and would "engage in discussions with the specific governments about the linkages and spillovers of the macroeconomic situation in relation to others and the global economy."

The IMF has set out on a number of occasions the global agenda it believes should be implemented. The US dollar should depreciate over the medium term while US savings need to increase, chiefly through cuts in budget deficits. China and other East Asian countries must increase the value of their currencies while boosting consumption spending at home, and the major European economies must introduce more market "flexibility" and cut deficits.

However, each of these policies has significant economic consequences and carries the risk of social conflicts. An increase in US savings, for example, means in one form or another significant cuts in the living standards of the working class, either through rising interest rates which impact on home mortgages or through further reductions in what remains of social welfare. A revaluation of the Chinese yuan creates problems for Chinese manufacturers operating on relatively small profit margins, creating the risk of increasing unemployment and social unrest. In Europe, the program of restructuring demanded by the IMF means more of the same kind of struggles as those that erupted in France over youth employment laws.

Those social tensions were evident when Rajan answered a question on Italy. He said the policy challenges facing the new government were "tremendous" and needed to be taken up on "almost a war footing." There was a "very substantial fiscal deficit", public debt was "extremely high" and Italy had been steadily losing competitiveness over the last few years. There had to be policy and structural reforms to "increase the level of competitiveness across the board."

While de Rato claimed the IMF's initiative on multilateral surveillance and consultation was a "very important step in the role of the fund in tackling global imbalances", achieving real co-operation and the implementation of significant measures will prove to be much more problematic.

This is because the imbalances themselves are the outcome of deep structural problems within the world capitalist economy. They began to grow at a rapid pace following the Asian economic crisis of 1997-98. One of the chief consequences of that crisis was the collapse of investment in the region. After falling by the equivalent of 7 percentage points of GDP, it has not experienced a significant recovery. This has led to the emergence of a "global savings glut"—the counterpart to the US balance of payments deficit.

The investment downturn in East Asia has been compounded by another significant process detailed in the latest *World Economic Outlook* report. Since the collapse of the sharemarket bubble in the early 2000s, and possibly earlier, major corporations have tended to run financial surpluses rather than undertaking new investments. Reversing their traditional position of borrowing funds to finance investment, they have now become suppliers of funds to financial markets.

The report pointed out that while the large current account surpluses in the so-called emerging market economies had been identified as the source of the "global savings glut", some $1.3 trillion of corporate saving (undistributed profits minus capital spending) in the Group of Seven industrial countries in 2003-04 was "more than twice the size of the accumulated current account surpluses of emerging market and developing countries during those two years."

While some of the increased savings by the nonfinancial corporate sector (NFCS) could be explained by increased profits, often the result of tax cuts and lower interest rates, "the decline in nominal capital spending explains around three quarters of the increase in NFCS net lending since 2000 in the G-7 countries. Simply put, firms have been investing a smaller share of their profits in upgrading and expanding their capital stock."

While the IMF report does not say so, such behaviour, in which firms place their profits into financial assets, rather than in new investment, is an expression of downward pressures on profit rates and difficulties in the capital accumulation process.

In "normal times" new investment by corporations is the driving force of the capitalist economy. New investment creates the demand for more jobs, and expansion of employment, coupled with increased wages, leads to increased consumer demand. But with a decline in investment, consumption demand and other forms of spending can only be sustained by increases in debt.

The IMF's report on the corporate turnaround is another indication of the fact that while global growth is at the highest levels for more than two decades, it is resting on increasingly shaky foundations.