

IMF growth forecast not as good as it looks

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The International Monetary Fund has forecast a growth rate of 4.8 percent for the world economy in 2008 in its latest *World Economic Outlook*, a slowdown from the growth rate of 5.2 percent for this year.

While the expected rate is 0.4 percent lower than the estimate of last July, it appears to indicate a still healthy expansion. Upon closer examination, however, a different picture begins to emerge.

The expansion in the world economy over the next year is heavily dependent on just three regions: China, Russia and India. The IMF calculates that these three economies alone accounted for one-half of global growth in the past year, with expansion also taking place in other so-called emerging market economies.

It is a different story in the major economies. In the United States, the projected growth rate is 1.9 percent for 2008, the same rate as in 2007 and a markdown of almost one percentage point compared to the IMF's previous forecast.

The IMF has also downgraded growth in the euro area and Japan to 2.1 percent and 1.7 percent respectively. IMF economic counsellor Simon Johnson told a press conference that "tighter credit conditions and slower export growth" were the main factors likely to dampen growth in the euro area, while for Japan the main factors were weaker export markets and "some softness in domestic spending."

The IMF's forecasts are based on the assumption that the effects of the credit crunch are being overcome and that "market liquidity is gradually restored in the coming months." But that may not be the case. As Johnson acknowledged: "The primary risks to the outlook are on the downside." Prolonged disruptions in financial markets and a possible weakening of asset prices and confidence could have a more severe impact on economic activity than anticipated.

Two days after these remarks, Wall Street seemed to confirm these warnings when the market fell more than

366 points, a decline of 2.6 percent, to finish the worst week since the end of July.

There could be worse to come. One of the factors that sent the market down was a warning from the giant equipment manufacturer Caterpillar that the US economy was "near to, or even in, recession."

And the financial crisis that erupted in July and August has by no means run its course, as Johnson acknowledged. "We still do not know precisely how the losses from the US subprime mortgage market will be distributed nor whether credit conditions will tighten further as expectations of losses affect bank behaviour," he said.

Johnson compared the unexpected development of the credit crisis to the movement of a forest fire. "Like a forest that has not seen a fire in many years, a benign financial environment, including low volatility and unusually narrow risk spreads, had built up a sizeable underbrush of risky loans, relaxed lending standards and high leverage in certain areas. When problems ignited in the US subprime mortgage market, the fire jumped in somewhat surprising ways to other areas."

There were three important "firebreaks" that should have limited the crisis but which did not hold.

One was the impact on other parts of credit markets, such as "jumbo mortgages" that usually involve less risky borrowers. The second jump was to the banks as revelations about the extent of their exposure to subprime mortgages shook confidence.

The third jump was to commercial paper markets where the market for asset-backed debt dried up leading to a run on the UK bank, Northern Rock, which was not involved in the US subprime market.

These "secondary fires", Johnson continued, were "still being addressed through liquidity operations by major central banks". While their actions had stabilised markets, the smoke had still not cleared.

The role of the central banks in lowering interest rates

to combat the crisis drew a pointed question from one of the journalists present.

“To take your analogy,” he asked Johnson, “isn’t just pumping lots of cheap money into financial markets a bit like sending an arsonist back into the forest with a box of matches, and, in a couple of years time, aren’t we going to be facing an even bigger forest fire?”

While defending the actions of the central banks in the short-term, Johnson conceded that his questioner was right in the longer term and had raised “legitimate concerns for the future.”

The *Financial Times* also offered some criticisms. *World Economic Optimism* would make a decent “alternative title” for the WEO report, it commented in an editorial last Wednesday. “The Fund’s analysts expect 2008 to be another year of strong growth for the world economy—at least on the surface. Look a little deeper, however, and their outlook for next year is much less pleasant.”

The *Financial Times* noted that the IMF’s forecasts were calculated at purchasing power parity, which gives additional weight to countries such as China and India where market exchange rates do not reflect what the renminbi and the rupee can actually buy on the domestic market. If market rates were used, the 2008 growth rate came down to 3.3 percent.

It pointed out that “market exchange rates are what matter to rich countries, and some businesses will feel pain. Growth of 1.9 percent in the US—well below trend and likely to mean rising unemployment and falling profits—will feel even worse.”

The IMF forecast, it concluded, was “as good as any other” but unlike the predictions earlier in the year “the risks to an optimistic outlook have become apparent.”



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