IMF warning on global downturn

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The International Monetary Fund (IMF) has added its voice to those of the World Bank and the United Nations in warning of a global slowdown and increased financial risks flowing from the eurozone crisis.

Revising its forecast for global growth in 2012 to 3.3 percent—0.7 percentage points lower than its September forecast—and warning of outright recession in Europe, the IMF said world recovery was threatened by “intensifying strains in the euro area and fragilities elsewhere.” Growth began to decline in the fourth quarter of 2011 “as the euro crisis entered a perilous new phase.”

While there had been higher than expected growth in the advanced economies, these developments were not expected to sustain significant momentum. In view of the often repeated claim that “emerging markets” will provide the basis for a new expansion of the world economy, the IMF’s comments on these regions were particularly significant.

Growth in these economies, the IMF report said, had “slowed more than forecast.” It put this down to the combined effects of tightening government spending and “weaker underlying growth.”

Warning that “downside risks” had “risen sharply,” the report said the most significant risk came from “the intensification of adverse feedback loops between sovereign and banking pressures in the euro area.” This refers to rising interest rates on the bonds of highly indebted governments, leading to a fall in the value of those bonds held by major banks, weakening their financial position, and raising the need for further government bailouts.

However, the risks are not confined to Europe. The IMF drew attention to the situation in “emerging economies,” which have experienced “buoyant credit and asset price growth as well as rising financial vulnerabilities.”

“This has buoyed demand and may have led to overestimation of trend growth rates in these economies,” the report stated. “Should the dynamics of real estate and credit markets unwind ... the impact on economic activity would be very damaging.”

While not mentioned by name, this description fits the Chinese economy. Concern is growing over the potential impact of a collapse of China’s highly-leveraged real estate and construction market, which has played a crucial role in sustaining growth rates since the global financial crisis began in 2008.

Summing up the present situation, the report said: “The current environment—characterised by fragile financial systems, high public deficits and debt, and interest rates close to the zero bound—provides fertile ground for self-perpetuating pessimism and the propagation of adverse shock, the most critical of which is the worsening of the crisis in the euro area.”

The release of the IMF report was preceded by a speech delivered by the fund’s managing director Christine Lagarde in Berlin on Monday. Pointing to the lower growth forecasts, she said they assumed a “constructive policy path” and that was by no means assured. In other words, the predictions are predicated on the unrealistic assumption that European governments can resolve the eurozone financial crisis.

Lagarde said that in too many places uncertainty was holding back demand and the willingness to lend. The year 2012 had to be a “year of healing,” she said.

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"Otherwise, we could easily slide into a '1930s moment'. A moment where trust and cooperation break down and countries turn inward. A moment, ultimately, leading to a downward spiral that could engulf the world."

Lagarde warned that such a moment could be sparked by inaction, insularity and rigid ideology. Her comments were clearly targeted at the German government and financial authorities. The IMF is pressing, against opposition in Berlin, for the provision of greater liquidity and for the European Central Bank to play an even more active role in the crisis. While her remarks were issued for effect, there is no denying their substance as the European financial system balances on a knife-edge.

Lagarde is pushing for a $1 trillion bailout fund warning that, without this "firewall," countries like Italy and Spain "could potentially be forced into a solvency crisis by abnormal financing costs" with "disastrous implications" for the stability of the global financial system.

In what amounted to a call for Germany to take greater responsibility for tackling the crisis, Lagarde said the euro area needed "some form of fiscal risk-sharing, which would allow for common support before economic dislocation in one country develops into costly fiscal and financial crisis for the entire euro area."

In a swipe at the opponents of increased funding, Lagarde pointed to the "worrisome tendency" to "view fiscal policy as a morality play between profligacy and responsibility."

As the IMF released its update, news from Japan pointed to the continuing slowdown in the major industrialised economies. It is expected that Japan will announce its first trade deficit since 1980, as a result of the eurozone crisis, the rising value of the yen, and natural disasters—last year's earthquake and the Thai floods.

Most forecasters believe that Japan will quickly move back into surplus but others warn that the latest figures could be the start of a trend if the world economy remains sluggish.

The Bank of Japan sees no great improvement on the horizon, warning in a statement yesterday that there was "heavy strain" in financial markets. The bank expected Japan's real gross domestic product to contract by 0.4 percent in the year ending March, instead of growing by 0.3 percent as it had previously forecast. Growth in the year to March 2013 is only expected to be 2 percent. This could well be revised down as well, especially if the downturn in the trade balance continues.

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