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OVERVIEW

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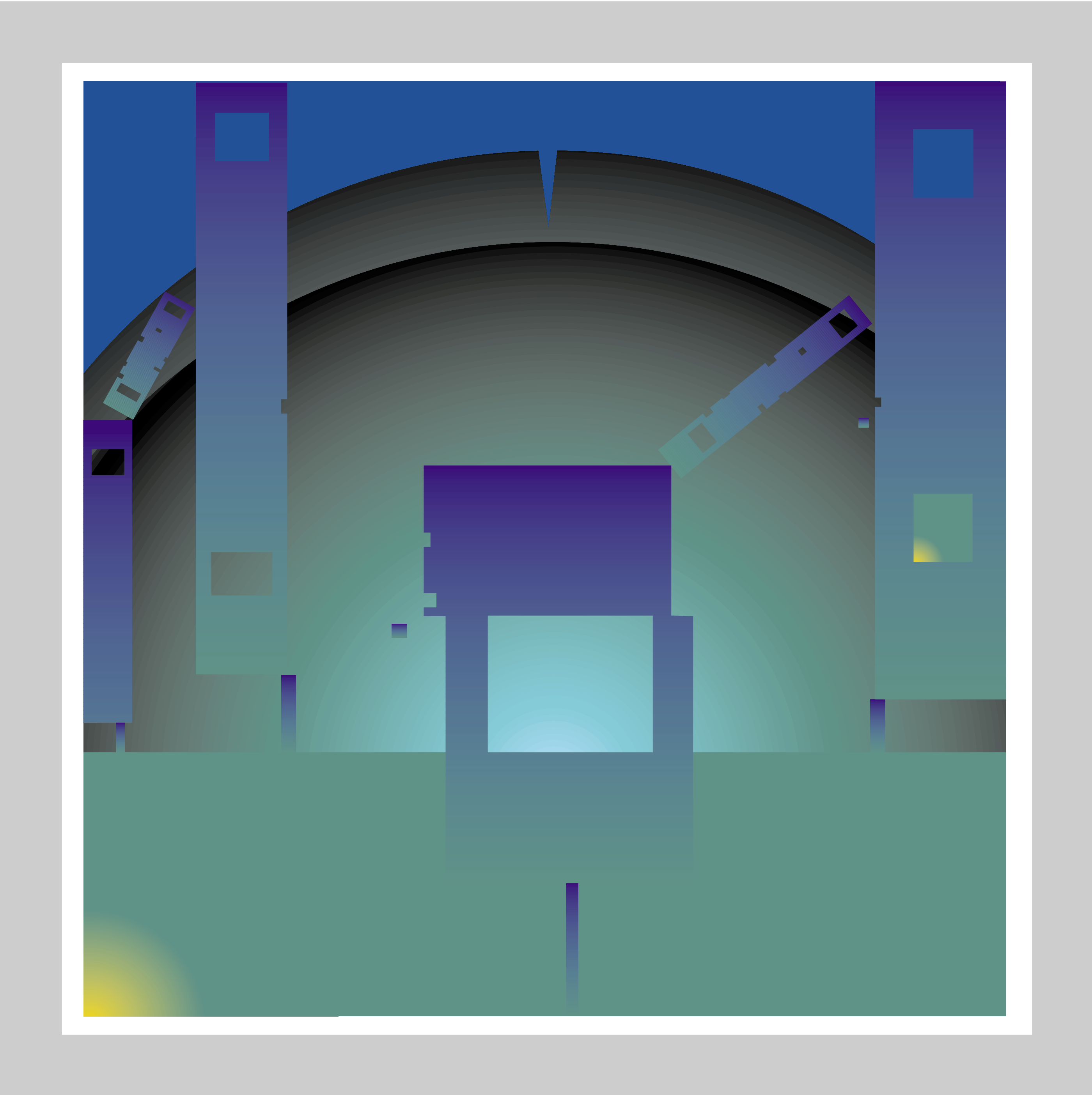

OVERVIEW

A quarter is a long time in economics. At the annual meetings of the Fund and Bank in Prague last September the mood was upbeat. The world economy had shrugged off a series of financial shocks in emerging markets, the United States economy was continuing to forge ahead, driven by the "new economy", Europe was at last showing signs of a robust recovery and Japan was beginning to emerge from a prolonged recession. Growth figures were being marked upwards. The only cloud on the horizon was rising oil prices.

The mood is different today. There are concerns about just how far and how fast the United States economy will slow down and whether traditional macroeconomic instruments can manage a rapid recovery; how vulnerable the dollar is; whether the nascent recovery in Japan will once again be nipped in the bud; whether the European locomotive can pick up sufficient speed to keep the world economy on track, and if not what a global downturn might mean for the still fragile recovery in Asia. On a more optimistic note, the oil cloud on the horizon has dissipated; prices had already peaked at the time of the Prague meetings. Conventional economic analysis is not, it seems, adapting very well to the gyrations of a globalizing world.

The UNCTAD secretariat has for some time been warning that excessive financial liberalization is creating a world of systemic instability and recurrent crises. A common response has been to blame such crises on misguided policies and crony investment practices in emerging markets. Whether similar accusations will surface as financial excesses and wasteful investments are exposed in the United States by economic slowdown remains to be seen, but they would be no more helpful than they were in the aftermath of the Asian crisis. Markets can and do get it wrong, and for developing and developed countries alike. The onus is still on policy makers to find preventive measures and appropriate remedies.

Certainly that task is difficult in a highly integrated world economy. But multilateral financial rules and institutions were established precisely to prevent a repetition of the inter-war economic chaos linked to persistent payments and currency disorders and excessive reliance on short-term capital flows. Sadly, since the break-up of the Bretton Woods system the world has been ill-prepared to deal with the re-emergence of such problems. Talk of far-reaching reform of the international financial architecture after the Asian crisis has proved to be no more than that. However, if a strong wind does pick up from the North, the consequences for the world economy will be much more chilling than those of the wind that blew in from the South. It is to be hoped that this threat will suffice to breathe new life into the reform efforts.

Global economic downturn and prospects

The performance of the world economy in 2000 was the best in over a decade. In every region growth edged upwards, with recoveries in Latin America and the transition economies that were stronger than expected. Moreover, this performance was achieved against the backdrop of sharply rising oil prices. While positive impulses from the previous year, notably the large liquidity injection to stave off the Y2K bug and to support the introduction of the euro, helped maintain the momentum, it was the continued strength of the United States economy that underpinned the 4 per cent growth in global output. To some observers, the combination of deregulated markets and new information technologies was putting pay to old-fashioned ideas about how economies worked, and many were looking forward eagerly to an unprecedented era of global prosperity.

Things changed dramatically over the last quarter of 2000 and into the new year. The United States economy began to slow sharply and the landing could well be harder than optimists had expected. The unwinding of its high-tech boom has produced a drop in investment spending, which has been aggravated by weaker consumer confidence and the threat of sizeable job losses in new and old economic sectors alike. The Federal Reserve reacted swiftly by cutting interest rates twice in January, with further cuts expected. The question that remains is whether the United States economy is experiencing the kind of cyclical downturn which will respond positively to such moves, and so ensure a quick rebound from two or three quarters of flat or negative growth back to a potential growth rate above 3 per cent. If the answer is in the negative, is the United States in for a longer period of disinvestment and debt restructuring with resemblances to those which occurred in Japan and parts of Europe in the early 1990s?

Expectations remain quite high that a short Keynesian downturn in the United States can be corrected by appropriate monetary and fiscal action. Some indicators at the beginning of the year provided grounds for guarded optimism: oil prices had dropped from their earlier peak; equity prices appeared to be stabilizing; and the trade balance had started to improve. The quick and decisive action taken by the Federal Reserve is also encouraging. The tax cuts that are under consideration, if appropriately timed and targeted, could further stabilize the situation.

But, even if the steady policy hand of recent years is maintained, there are doubts that traditional macroeconomic policies will carry the day, given the high level of private indebtedness, the surfeit of investment during the technology boom, and uncertainties surrounding the dollar. While the public sector prepares to pay off its outstanding debt, the private sector has attained record debt levels. As households see their income growth decline, they will have to borrow more in order to maintain current spending, at precisely the time when it is becoming more difficult for them to keep up with payments on their outstanding debt. At the same time, much of the high-tech Schumpeterian investment sustained by the venture capital boom and the stock market bubble may be destroyed with a return to normal financing conditions. If households and the business sector were to simultaneously limit their spending to current earnings, there could be a significant decline in GDP.

The fact that such a long period of expansion has no recent precedent should make for cautious assessment of the current slowdown. However, on balance, the various conflicting pressures point to an uncertain future; any abrupt shifts in sentiment or policy could still make for a deeper downturn than many are expecting and prejudice a swift recovery.

In view of its pivotal role in bolstering global demand in recent years, the prospects for the United States economy are a matter of worldwide concern. The increasing integration of the global economy certainly means that both real and financial shocks are transmitted much more rapidly across regions, countries and sectors. At the same time, because of the intertwining of finance and production, such shocks can have unexpected consequences, as has been demonstrated by the financial crises which began in Asia in 1997.

Whatever the immediate future holds in store for the United States, the long-term fate of the global economy cannot be left to be determined by policies and events in a single country. In the context of growing interdependence, all the major industrial economies need to harmonize their forces, if the gains from globalization are to be widely distributed and, in particular, to reach down to developing countries. Accordingly, "business as usual" is not the right mantra for policy makers anywhere.

Growth in Europe in 2000 broke through the 3 per cent barrier for the first time in over a decade, but leading indicators point to a slowdown in 2001. Now that budget deficits have been brought under control, the current account is healthy and there are few signs of inflationary pressure, the way is clear for a shift to expansionary macroeconomic policy. With interest rates falling in the United States and the prospect of a recovery of the euro which should further ease the pressure on monetary policy, Europe seems well placed to take on global economic responsibilities and boost global demand, thus offsetting the effects of slowdown in the United States. However, the EU appears reluctant to test the limits of its potential growth, as the United States did in the second half of the 1990s. Yet such action is also necessary in order to overcome its persistent and high unemployment. The European Central Bank maintains that it sees no signs of the potential growth rate in the euro area rising above a modest 2.0–2.5 per cent, implying that it sees no immediate scope for relaxing monetary policy without inflationary consequences. This stance may need to be reconsidered if, as seems likely, the EU is hit harder by a slowdown in the United States than might be suggested by its limited trade ties with that country.

Japan is unlikely to fill the breach, given its fragile recovery and the importance to it of the United States market. Its nascent expansion, which looked healthy in the first half of 2000, was built on rising net exports, but negative growth was resumed in the third quarter of the year. A lower dollar and weaker demand in the United States market place the burden of recovery on strong domestic demand. But since domestic investment is still closely tied to exports, and unemployment is again edging upwards, it is not at all clear from where the impulse will come.

Governments in Japan have repeatedly responded to sluggish growth with more active fiscal measures, but now that public debt is at an unprecedently high level pressure for fiscal consolidation is starting to impact on macroeconomic policy. Considerable uncertainty also surrounds the future direction of monetary policy; the Central Bank no longer seems willing to hold itself to a zero interest-rate policy, which it views as an impediment to financial structuring. With liquidity and fiscal traps snapping shut and export prospects darkening, recovery may once more be cut off just as it gathers momentum.

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Much still depends on the readings and actions of policy makers in Washington and it is premature to give the global economy a clean bill of health. Even if Europe in 2001 were to match the earlier United States growth performance, that would not have the same effect on the developing world, since it has a lower propensity to import from those countries. The downside risks for developing countries are thus considerable.

Trade flows are one channel for contagion from a United States slowdown. The danger is apparent from the Asian experience, when slower growth in high-tech exports played an important role in the build-up of external fragility and the impact of the subsequent financial shock was amplified through intraregional trade. Just as significantly, strong export growth has played a key role in the Asian recovery. In 2000 the growth of United States imports reached double-digit figures for the third year running. The benefits to developing countries and transition economies were particularly marked, their total export volumes being estimated to have risen by over 10 and 15 per cent, respectively. A further factor in their favour was an improvement in their terms of trade on account of sustained oil price rises. The prospects for this year are much less favourable.

Financial and currency markets are another channel for contagion. Falling United States interest rates will certainly benefit countries with large stocks of dollar debt. Capital flows could also be redirected to emerging markets as smaller profits in the United States discourage inflows of capital seeking to join in the high-tech revolution and falling interest rates dampen short-term arbitrage inflows. However, it is equally possible that the United States slowdown will accentuate the bearish sentiment in global financial markets, raising the liquidity premium on dollar assets and the risk spread on emerging-market borrowing, thereby wiping out the benefits of lower United States interest rates. In that event, capital flows to developing countries would scarcely exceed their disappointing levels of 2000.

The presence of different channels of transmission suggests that the United States slowdown will be felt very differently in different regions of the developing world. East Asia was the fastest-growing region last year. After strong recoveries in 1999 in most of the economies damaged by the financial turmoil of 1997–1998, growth accelerated further in 2000. Exports to the United States, which amount to more than 20 per cent of GDP in Malaysia, 10 per cent in Thailand, and 7 per cent in the Republic of Korea, played a key role, especially exports from high-tech sectors. The current combination of declining sales in the United States and falling semiconductor prices has resulted in terms-of-trade losses and declining export earnings for all these countries. Growth is consequently expected to fall throughout the region this year. Intraregional trade linkages could once again amplify the negative impact of these shocks, triggering a further round of destabilizing exchange rate swings across the region. Moreover, the economies are slowing down at a time when financial and corporate restructuring is running into difficulties in a number of countries.

The economy of China is also sensitive to developments in the United States, which absorbs over 20 per cent of its exports. While robust growth last year gives grounds for hope that China can weather the downturn in the United States as well as it did the Asian crisis, the task of striking the right policy balance is being complicated by protracted, and as yet unfinished, negotiations over accession to WTO. The prospect of Chinese accession in the near future is also a matter of concern among some of the smaller labour-intensive exporters in Asia, who fear losing competitiveness at the very time when their export prospects are blackened by weakening import demand in the United States.

The impact of a United States slowdown on Latin America is more difficult to gauge. Recovery in that region was stronger than expected in 2000, when growth reached close to 4 per cent, after stagnation in the previous year. However, the aggregate picture hides much variation among countries. Mexico, which accounts for one fifth of regional output, witnessed growth of around 7 per cent, reflecting its close economic ties to the United States (which takes some 85–90 per cent of Mexican exports), as well as the rise in the export prices of its oil. It seems unlikely that the Mexican economy will be able to escape the consequences of the slowdown in the United States, although lower interest rates could be helpful. In addition, there is concern, shared with some other Central American and Caribbean countries, over the prospect of greater competition from China after its accession to WTO.

The impact on the rest of Latin America is likely to be different. In view of the weaker trade links with the United States and the heavy dependence on capital inflows, improved external financial conditions may more than offset the effect on their exports of reduced demand in the United States. In the absence of a significant increase in risk spreads, lower interest rates in that country should mean reduced borrowing costs and debt servicing, easing the pressure on balances of payments and budgets. Furthermore, for countries which have opted for a currency board or outright dollarization a weaker dollar improves competitiveness vis-à-vis third parties. Argentina may turn out to be a big winner on both counts, emerging from the vicious circle of stagnation and deflationary adjustment to the external shocks of 1998–1999. Brazil should also benefit from improved financial conditions, though to a lesser extent.

Despite some grounds for optimism, the real danger facing Latin America is one of diminished expectations. Policy makers throughout the region appear content to target growth in the 3–4 per cent range, well below what is required to promote graduation to the next level of development. Moreover, with more countries choosing dollarization, dependence on conditions and policy decisions in the United States is increasing. A deeper downturn there, bringing with it a new round of financial uncertainty and reassessment of risks, could well wipe out the potential benefits of a weaker dollar and lower interest rates and, together with a slowdown in exports, could produce a further setback to growth prospects.

As regards Africa, there is a certain degree of asymmetry in the impact of fluctuations in global economic activity. Because of supply-side rigidities, African LDCs that rely on exports of only one or two primary commodities cannot take full advantage of global expansion by increasing their export volumes, while they often bear the full brunt of commodity price declines. Prices of many of the commodities exported from Africa were falling in the 1990s. The rise in oil prices benefited some countries in 1999, and again in 2000, but for others, particularly the many that depend on oil imports, the consequence was a further widening of the resource gap.

Thus, despite the strong growth in the world economy in 2000, Africa's growth rate rose only modestly, to 3.5 per cent, which is below the rate reached before the Asian financial crisis and well below what is needed to tackle the problems of rising poverty and declining health. Even before the slowdown in the United States, growth forecasts were being revised downwards because of the continued sluggishness of some of the larger economies, severe weather conditions and disruptions caused by civil and political unrest.

In these circumstances, any global shock could be particularly damaging for African countries. Not surprisingly, aid and debt relief remain high on their political agendas. The region should benefit from bilateral debt reduction accorded by some industrialized countries to the poorest economies, as well as from recent European and United States initiatives to open up their markets to the poorest economies in Africa. However, with progress on the HIPC Initiative still much too slow, and a growing acknowledgement that the financial benefits are much smaller than expected, there is an urgent need for a bolder approach to multilateral debt relief.

The transition economies benefited considerably from favourable trading conditions in 2000. For the first time since the Berlin Wall fell, GDP increased in all countries. Growth in the Russian Federation rose sharply, thanks to strong demand for its primary exports, particularly oil. Elsewhere, it was the industrial sector that underpinned improvements, notably those of Eastern European countries, which benefited from strong export growth of manufactures to the EU. Even so, the fact that the recovery is from a low base, and occurred in favourable global demand conditions, means that a slowdown in the world economy will be felt by many of the transition economies and that any further recovery will have to come largely from a stimulus originating in domestic demand.

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The downturn in the United States, unresolved structural difficulties and sluggish growth in Japan, and undue emphasis that monetary policy continues to place on inflation in Europe have the consequence that the major industrial countries will be converging towards a slower pace of economic activity. Despite decisive policy action, rapid recovery in the United States economy is jeopardized by the financial excesses associated with its unprecedented period of expansion. Furthermore, an orderly transition to a world where all the leading economies are pulling in the same direction is further complicated by the uncertainty surrounding exchange rate adjustments to the trade imbalances which have built up over the past few years. A rapid weakening of the dollar would not only compromise the ability of monetary policy in the United States to respond vigorously to a deepening of the downturn, but could also expose financial fragilities elsewhere. For all these reasons the downturn and instability in the world economy could be more pronounced than under normal cyclical conditions. Consequently, cooperation among, and responsible action by, all major players in the world economy becomes all the more necessary.

Reforming the international financial architecture

Between the myopia of global markets and the myth of global government, multilateral rules and institutions can help reduce market volatility and prevent mutually incompatible policy responses to economic shocks. For the architects of the post-war multilateral system who gathered at Bretton Woods, history had taught that financial markets were a particularly fecund source of instability and shocks, and that control over international capital flows was a precondition for currency stability, the revival of trade and economic growth and the achievement of full employment.

The breakdown of the Bretton Woods system in the early 1970s initiated a period of financial and economic uncertainty and instability that shares at least some of the characteristics of the inter-war period. Various initiatives have been pursued in different forums in the hope of finding a system of