T T Mboweni: Prospects for the global economy in 2002

Speech by Mr T T Mboweni, Governor of the South African Reserve Bank, at the Nieman Society of Southern Africa Annual Dinner, Cape Town, 9 February 2002.

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1. Introduction

Ladies and Gentlemen. I thank you for inviting me to speak at this, your annual dinner. I congratulate you as a group of individuals who have been recognized for your excellence. You have a responsibility to continue this pursuit of excellence. Indeed, this should be a guiding characteristic for all of us.

The year 2001 can appropriately be described as a depressing year. It started with the sudden cut in the US Federal Funds rate, which marked the first official acknowledgement of the unexpectedly sharp and sudden downturn in the US economy. The slowdown of the US growth juggernaut after almost a decade of exceptional growth had a profound effect on most countries and regions. Initially there was a widespread belief that the euro area would be insulated from the fallout, given the high levels of intra-regional trade. It soon became clear that this optimism was misplaced, and that Europe would not replace the US as the locomotive for world growth. Not surprisingly, most emerging markets followed soon after. This was particularly the case in the technology-dependent Asian countries which were badly affected by the bursting of the Nasdaq bubble. The generalised slowdown was further exacerbated by the tragic events of September 11, which turned out to be the low point of a bad year.

Although 2002 started off with many economies either in recession or close to it, the mood is one of cautious optimism that the worst of the global downturn is behind us. Growth forecasts are being continually revised by all the major fund managers and multilateral organisations. The latest forecast from the International Monetary Fund in December is for world growth of 2,4 per cent, the same as for 2001. However this figure was marked down significantly from the 3,5 per cent predicted in the October World Economic Outlook (WEO). The latter forecasts had been prepared before the September 11 events. Despite the significantly lower global growth forecast, these numbers do assume a recovery from the second half of the year.

2. Increase synchronisation of cycles

The current downturn has strongly reinforced the pivotal role of the US economy. Strong US growth had been instrumental in overcoming the Asian crisis of 1997/8. The story could have been very different had the US and Europe not been growing strongly at the time. In 2001 it was the locomotive itself that had stalled, resulting in a generalised world downturn.

The nature of this downturn has implications for the future prospects for the world economy. Few analyses of the current downturn fail to mention the increased synchronicity of economic cycles across regions. In April 2001 the UNCTAD Trade and Development Report had argued that without a co-ordinated global policy response, the slowdown in the United States would produce a synchronous cyclical downturn in the world economy. In December the IMF World Economic Outlook remarked that a particularly disturbing feature of the current slowdown is its synchronicity across nearly all regions, "the most marked for at least two decades." The WEO attributes this partly to common shocks, (including the sharp oil price increases) and the bursting of the information technology bubble, both of which had a world-wide impact. Furthermore, increased international linkages, particularly in the financial and corporate sectors, have played an important role, and this is expected to be a continuing trend. Finally it is argued that the synchronicity of the downturn may also reflect delays in implementing structural reforms, notably in Japan and the euro area, resulting in these countries being less well placed to take up the slack when the long expansion in the United States came to an end.

Although the downturn was strongly synchronised, there is less agreement as to whether this will apply to the recovery. There seems little doubt, though, that the US will lead the global upturn. Some analysts argue that although the downturn was synchronised, the US recovery would considerably precede the European and Japanese recoveries. Others argue that synchronisation on the downside means synchronisation on the upside as well. Early indications are that the emerging Asian economies are likely to be in the best position to follow a US manufacturing upturn.

3. Outlook for the United States

The general consensus is that the US economy is likely to make a significant recovery by the middle of the year. If the forecasts are correct, it will have been one of the mildest US recessions ever. Although the WEO forecasts a US growth rate of only 0,7 per cent for the year, this assumes a considerable strengthening during the year and growth in the fourth quarter of 2002 is expected to be 2,5 per cent compared to the fourth quarter of 2001. A number of factors appear to confirm this imminent recovery. The lower oil price will play its part, and there are also signs that the US has reached the bottom of the inventory cycle. Higher equity prices and more positive consumer and business sentiment are also apparent in various surveys.

Added to this is the fact that a significant amount of macroeconomic stimulus is on the way. Although the Fed appears to have ended its cycle of monetary easing, the full effects of the progressive declines in interest rates are still to be felt. Furthermore, fiscal policy changes are still being implemented. Although the tax reform bill got held up in Congress, the increase in government expenditure in the fourth quarter will compensate for this in the meantime.

A further indicator of the turnaround is the recently released fourth quarter growth figures which were unexpectedly high and point to the possibility that the US recession may be over, or at the least that the worst is over. Underpinning this low but positive growth number of 0,2 per cent are sustained high levels of consumer expenditure, which account for almost two thirds of economic activity in the US.

However we should be rather cautious before jumping to premature conclusions on the basis of these figures. Firstly, expenditure on durable goods increased by an unsustainable 38.4 per cent (quarter-on-quarter annualised) compared with an increase of 0,9 per cent in the third quarter. This was mainly due to the zero interest financing incentives offered on durables, particularly motor vehicles. Secondly, we should not be too surprised if the revised figures for the fourth quarter (due on 28 February) are significantly different to that of the provisional data which are "advance estimates". We need only think back to the third quarter of 2001 when the initial estimates for quarterly US GDP growth were an unexpectedly high at –0,4 per cent, whereas the final estimates were –1,3 per cent, more in line with the original expectations. Therefore the chances are good that the final figures for the fourth quarter will be significantly different to what has been published. Whatever the final figures, consumer confidence surveys do suggest that consumer confidence indices have reached their highest levels since August, suggesting that the worst may well be over.

Despite increasingly positive indicators, analysts are, however, divided about the strength and the sustainability of the recovery in the US. There is a widely held view that the turnaround will either be subdued, or of limited duration, or even turn out to be a "double dip" if final demand does not respond to the initial inventory build-up. The basis for this view is the historically high level of debt of US households and corporations. It is argued that for a sustained recovery, consumer spending needs to rise significantly. However this will be constrained by the fact that debt-strapped consumers will have little scope for increasing levels of consumption which remained uncharacteristically high during the recession (and which contributed to the mildness of the recession). As The Economist recently noted, ‘the root cause of this recession was the bursting of one of the biggest financial bubbles in history. It is wishful thinking to believe that such a binge can be followed by one of the mildest recessions in history- and a resumption of rapid growth.’

Notwithstanding the fears about private and corporate debt build-ups, the US Fed is fairly sanguine about the state of the banking system, a view widely shared by the optimists. At a meeting at the Bank for International Settlements earlier in 2001, US Fed officials argued that relative to other recessions the banking system was in a very healthy position. This could allow for a quick recovery as the banking system would not have to go through a period of restructuring and consolidation. Such restructuring inevitably holds up the pace of recovery for which bank credit is an important element. The relatively healthy state of the banking system is a major reason why the US recession is unlikely to become a Japanese-type deflation.

4. The Euro area

The current downturn has shown that the euro area is more dependent on the fortunes of the US economy than was previously believed. Despite the high level of intra-regional trade, a significant proportion of trade between the US and Europe was between subsidiaries of multinational companies. According to IMF estimates, this related-party trade accounted for approximately 65 per cent of all US imports from Germany in 2000. Apart from this trade channel, increased European investment in the

US made the euro area more vulnerable to declines in US profits and equity prices. These factors also make the euro area increasingly dependent on the US for a recovery stimulus.

The IMF forecast for the euro area is 1,2 per cent for 2002, a full percentage point lower than projected in October. However within the euro area a fairly wide dispersion of growth rates is expected, with German growth expected to be a weak 0,7 per cent, compared to 1,3 per cent in France.

A widely held view, echoed by the OECD Economic Outlook and the IMF is that in order to underpin a recovery and to raise potential output, Europe requires more structural reforms to overcome existing rigidities that characterise the region. The OECD Economic Outlook for example had argued that more needs to be done "to reduce rigidities, encourage labour supply, lower structural unemployment and improve the entrepreneurial climate. Product markets are also still too segmented and financial markets not well integrated….."

Unlike in the US, there will be less reliance on direct macroeconomic stimulation. There appears to be little scope for fiscal stimulation in the face of increased budget deficits as a result of lower tax receipts and the need to maintain fiscal sustainability. As in many countries and regions, a disproportionately heavy burden for adjustment has been placed on monetary policy for macroeconomic stabilisation. The ECB has, correctly in my view, maintained a determined focus on inflation outcomes, and has had to endure criticism from a wide variety of quarters. But the bottom line is that the euro area, as elsewhere, cannot rely on its central bank to be the growth engine.

5. Japan

Japan experienced two recessions and persistently low growth throughout the 1990s. Unfortunately the outlook for Japan remains negative, partly because restructuring of the banking system is taking longer than anticipated. Although the IMF expects a modest recovery later on in the year, for the year as a whole the economy is expected to contract by 1 per cent with continuing deflation. This outlook has a high level of risk, particularly on the downside. According to the WEO, a key concern is of a vicious cycle involving weakening growth, increased corporate bankruptcies and increasing concerns about the health of the banking sector.

The roots of the Japanese crisis lie in the deregulation of the bond market which meant that the banks' traditional corporate customers found cheaper financing elsewhere. The need for the banks to find new lines of business resulted in increased speculative property lending, at the height of the Japanese property bubble. In addition, lending was increased to borrowers in emerging Asian countries and the banks also bought equity at the height of the stock market boom. When the stock and property markets crashed, and the Asian crisis hit, the results for the financial sector were disastrous.

Even before September 11, the Japanese economy had entered a new period of weakness, and is now effectively caught in a situation where the traditional macroeconomic responses are constrained. The low levels of interest rates mean that the Bank of Japan has limited scope for an effective response. Fiscal policy was seen as the main policy tool, but very quickly the debt to GDP ratio rose to alarmingly high levels at about 135 per cent, the highest in the OECD. This of course puts a brake on further fiscal stimuli, although tax reform measures have been mooted for later this year. At the same time the new reform programme committed the government to a reduced deficit at a time when unemployment had reached the highest levels in 34 years. Furthermore, discretionary fiscal actions could well be offset by higher household saving, due to increased concerns about long-term fiscal sustainability.

Japan is not only in trouble due to problems with its banking sector, it also has suffered from the bursting of the IT bubble. Exports have declined significantly over the past year and continued weakness in the electronics market is expected. Most indicators remain negative, particularly in the manufacturing sector which is characterised by excess capacity, declining employment and falling inventories. Japan will be helped to some extent by an upswing in the US and Asia. What is clear however is that Japan will not be one of the locomotives of that upswing. Despite the rhetoric to the contrary, there does not seem to be the political will deal with the problem of the non-performing bank loans. This will have macroeconomic costs in the short-run, but the reform of the banking system and corporate restructuring is essential for the overall recovery of Japan.

6. Emerging markets

Not surprisingly the downturn in the industrial countries resulted in widespread declines in economic activity in developing countries and a less favourable environment for international trade and financial flows. Weak global growth hits those economies most that are dependent on trade, irrespective of whether they are exporters of technology or manufacturing, or commodity exporters. Furthermore emerging markets are negatively affected by the decline in capital flows and the increased risk aversion of investors. The Institute of International Finance, for example, estimated inflows to emerging markets for 2001 at US$106 billion, compared with the earlier forecast of US$140 billion. The decline is ascribed to heightened risk aversion. Similarly, while world exports were expected to rise by 2,5 per cent last year, earnings of emerging markets were projected to decline by 2 per cent.

7. Asia

The weakness of Japan is not only a problem for the broader global recovery, but for emerging Asia in particular. Most of the Asian countries have strong export ties to Japan and the continued weakness blocks off an important export destination. One factor that could offset this is the continuing emergence of China which has to a large extent been shielded from the downturn. At the East Asia regional summit of the World Economic Forum held in Hong Kong in October of 2001, developments in the Chinese economy dominated the discussions. Although the emergence of China was seen as positive for the region, it was also viewed with some trepidation in some of the countries, particularly Hong Kong. It is an irony that the most closed economies in Asia i.e. China and Japan, determine the future prospects of some of the most open economies in the world.

Growth projections for Asia were also revised down by the IMF, with recovery delayed into 2002. The newly industrialised economies of Asian and ASEAN were badly affected by the lower European, Japanese and US growth and the collapse of the global electronics cycle, with Hong Kong and Singapore being particularly vulnerable, and Taiwan experiencing its first recession since World War II. These countries are only expected to grow by around 1 per cent in 2002. The forecast for the ASEAN countries for 2002 is 2,9 per cent, although for developing Asia the forecast is 5,6 per cent, buoyed by a 6,8 growth forecast for China. Although the outlook for this region is relatively bright, particularly given the lower dependence on external capital flows, its heavy exposure to the electronics cycle make it vulnerable to developments in that industry.

8. Latin America

The outlook for Latin America remains overshadowed by developments in Argentina, but it appears that the worst of the contagion effects appear to be over. Although the Argentinean crisis was not caused by the general world downturn, the satisfactory resolution of the crisis in Argentina does have an implication for the general ‘risk appetite’ in the industrial countries, and therefore for capital flows to emerging markets in general. The adjustment in Argentina is likely to be painful, and drawn-out, and is likely to remain a source of economic uncertainty and instability for some time and the recession is expected to persist through 2002.

Latin American growth in general is forecast to be 1,7 per cent in 2002, with Mexico having the lowest growth forecast at 1,2 per cent (apart form Argentina). Mexico’s membership of NAFTA makes it more vulnerable to economic downturn in the US, whereas other Latin American countries have greater trade exposure to Europe. External financing requirements are relatively large in this region, and growth prospects will therefore be affected by a resumption of ‘normal’ capital flows.

9. Africa

The IMF’s growth forecast for Africa is a relatively high 3,5 per cent for this year. But a wide dispersion of growth rates is expected, reflecting variations in the mix of commodity dependence, economic policy developments and other country-specific influences. For example Mozambique is expected to grow by 8 per cent while the Zimbabwean economy is forecast to contract by around 6 per cent. Africa is expected to be affected most by developments in commodity prices. Oil exporters such as Algeria, Angola, Nigeria will be negatively affected by lower oil prices, although this will provide a cushion to oil importers. The view of the WEO however is that the growth outlook for many African economies is expected to be held back by falling prices of almost all non-fuel commodities, especially coffee and cotton.

The stronger the general global recovery, the quicker these commodity prices are expected to recover. However the problem is that a strong global recovery could result in oil price developments that swamp the positive impact on many of the commodities that African countries are dependent upon.

The IMF forecasts growth for South Africa at 2,3 per cent for 2002. Just as the rest of Africa will be affected by developments in commodity prices, so too will South Africa.

10. Conclusion

In conclusion, the United States appears to be on the brink of a turnaround from what will have been a relatively short and mild recession. Unfortunately other countries were not so fortunate, and their recoveries remain dependent on the strength and duration of the US recovery. From a South African perspective, this bodes well for a recovery in commodity prices, and therefore an improved export performance. However there is always the risk that the prophets of doom will be correct and that the recovery in the US and therefore in the rest of the world will be short-lived.

What the current recession has highlighted is the increased dependence of the world on the health of the US economy. Whereas there had been a view that the emergence of different trading blocs such as the EU and an Asian bloc (a tri-polar solution) could reduce dependence on the US, trade and financial linkages have become even stronger, thereby increasing the degree of synchronicity. The recession has also highlighted the disproportionate burden placed on monetary policy to bring about the required real adjustments.

This raises a question of the efficiency of the current international financial architecture that renders the whole world increasingly dependent on the state of the US economy. Emerging markets are hardest hit as capital flows dry up precisely at times when they are needed. There is a need for global mechanisms to inject international liquidity into the world economy during times of stress. Reform of the international financial system is always on the agenda, but very little progress gets made. Discussions are intensified during times of crisis - following the Asian crisis there was much talk about reforms that would prevent a repeat of such crises. The resolution of the crisis reduced the urgency for such reforms. Similarly, the end of the current global recession will reduce the pressures for reform, particularly of financing arrangements, for emerging markets. But there is clearly something amiss with a system that is increasingly centralised. Unless there is concerted pressure for reform in the multilateral organisations, little will be done until the next crisis is upon us. There is a growing recognition that the fate of the world economy cannot and should not be left to the policy responses of the US to events in that country.

Thank you.