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November 8, 2001

To: Members of the Executive Board

From: The Secretary

Subject: **Note of the Managing Director to the International Monetary and Financial Committee—Initial Assessment of Prospects for the Global Economy Following the Events of September 11**

The attached note of the Managing Director to the IMFC on the initial assessment of prospects for the global economy following the events of September 11, including a summary of the staff's most recent projections, provides background material for the WEMD discussion tomorrow, Friday, November 9, 2001. The note will be revised in the light of comments by Executive Directors and transmitted to the IMFC on Tuesday, November 13.

Questions may be referred to Mr. D.J. Robinson (ext. 37489) and Mr. Bayoumi (ext. 36333).

Att: (1)

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Department Heads

Managing Director's Note
for the International Monetary and Financial Committee:
An Initial Assessment of Prospects for the
Global Economy Following the Events of September 11

Saturday, November 17

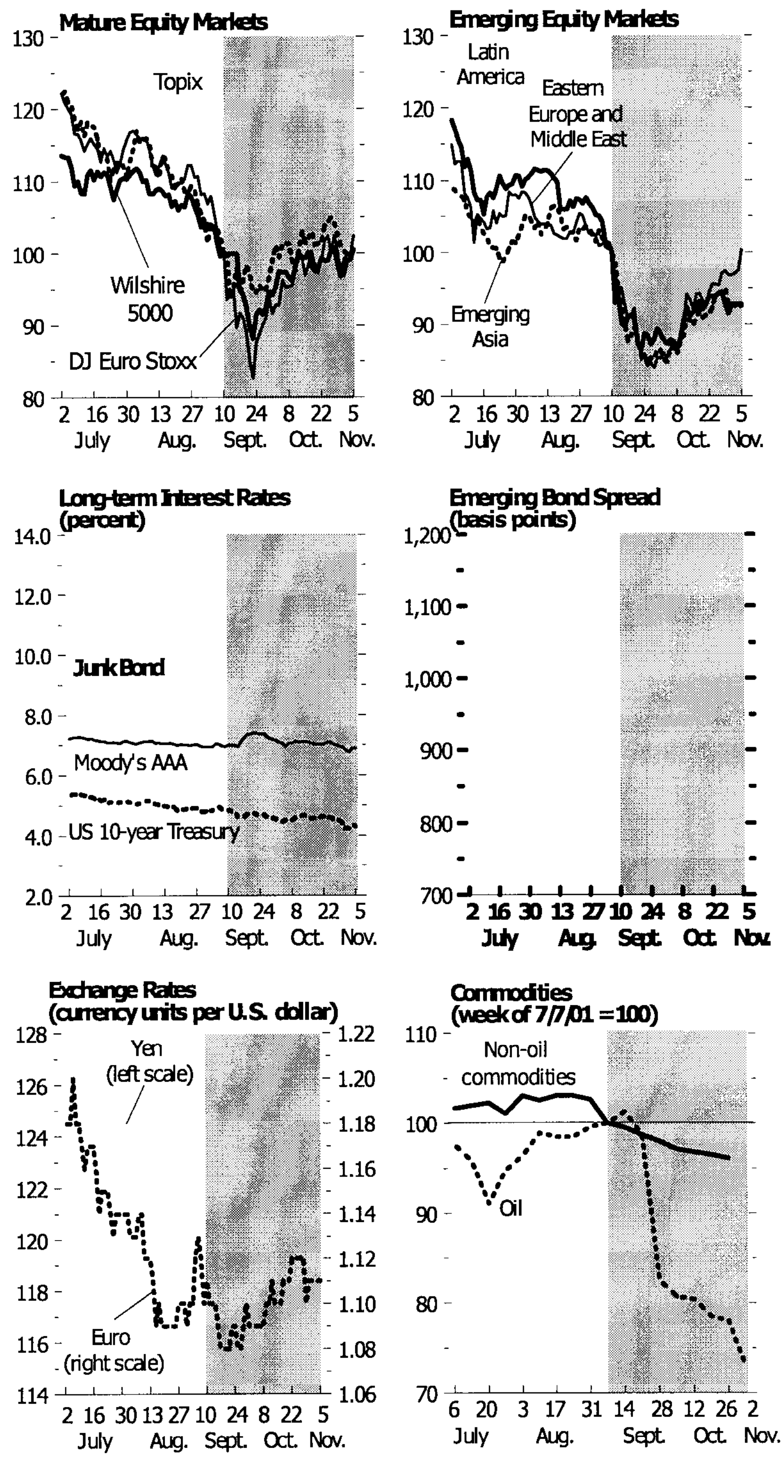
Since late 2000, the global economy has been experiencing a synchronized slowdown. Growth has weakened sharply in almost all major regions of the world, accompanied by a marked decline in trade growth and deteriorating financing conditions in emerging markets. Before the terrorist attacks of September 11, it appeared that there was a reasonable prospect of recovery in late 2001. However, more recent data indicate that the situation before the attacks was weaker than earlier projected in a number of regions, including the United States, Europe, and Japan, as well as a number of emerging market economies in Asia and Latin America.

From the perspective of the global economy, the tragic events of September 11 therefore came at a particularly difficult time. Since the attacks, consumer and business confidence have weakened across the globe, and there has been a generalized shift away from risky assets in both mature and emerging markets (Figure 1). Preliminary data confirm a significant initial impact on demand and activity in the United States and other industrial countries. With the outlook for global growth weakening, commodity prices have fallen, particularly for oil, as have equity values in many emerging markets. In contrast, after falling sharply in the fortnight after the attacks, industrial country equity markets have subsequently recovered their losses, while exchange rate movements among major currencies have generally been moderate, with both the euro and the yen recently depreciating somewhat against the U.S. dollar.

At the present juncture, the outlook remains subject to great uncertainty. It is extremely hard to form a judgment on whether the recent deterioration in confidence and increase in risk aversion will be relatively short-lived or more prolonged, with much continuing to depend on non-economic developments, including the war in Afghanistan. That said, macroeconomic policy in many parts of the world—particularly in the United States—has moved to sustain activity. In addition, for many countries lower oil prices will be supportive of recovery, while low inflation and strong fiscal positions are providing considerable room for maneuver for macroeconomic policies. The resilience of many emerging markets to shocks has also been improved over recent years by the adoption of flexible exchange rate regimes, stronger reserve positions, and more limited short-term obligations, as well as reforms of the international financial system. We therefore continue to expect that a recovery will develop during 2002.

The staff's revised baseline projections envisage that the global slowdown will be more prolonged than foreseen in the October 2001 *World Economic Outlook*, with recovery being delayed until around the middle of 2002. As a result, global GDP growth has been revised downward by 0.2 percentage points to 2.4 percent for 2001 (Table 1 and Figure 2), and by one percentage point to 2.5 percent for 2002:

Figure 1. Selected Financial Market Indicators
(September 10, 2001 = 100 unless otherwise noted)



Source: Bloomberg Financial Markets, LP and IMF staff estimates.

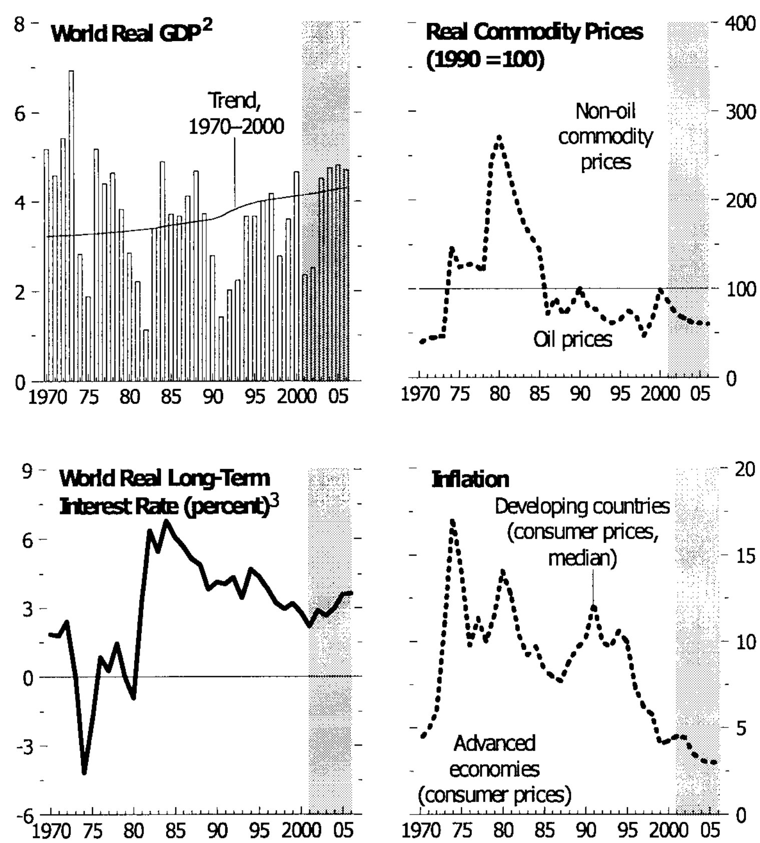
Table 1. Overview of the Baseline Projections
(Annual percent change unless otherwise noted)

	1999	2000	Current Projections 2001	Current Projections 2002	Difference from October 2001 Projections[1] 2001	Difference from October 2001 Projections[1] 2002
World output	3.6	4.7	2.4	2.5	-0.2	-1.0
Advanced economies	3.4	3.8	1.0	0.8	-0.3	-1.3
Major advanced economies	3.0	3.4	0.9	0.6	-0.2	-1.3
United States	4.1	4.1	1.1	0.7	-0.3	-1.5
Japan	0.8	1.5	-1.0	-1.3	-0.5	-1.6
Germany	1.8	3.0	0.7	0.8	-0.1	-1.0
France	3.0	3.4	2.0	1.3	--	-0.8
Italy	1.6	2.9	1.8	1.2	0.1	-0.8
United Kingdom	2.1	2.9	2.3	1.8	0.2	-0.6
Canada	5.1	4.4	1.4	0.8	-0.5	-1.4
Other advanced economies	4.9	5.2	1.4	1.9	-0.5	-1.3
Memorandum						
European Union	2.6	3.4	1.7	1.4	-0.1	-0.8
Euro area	2.7	3.5	1.6	1.3	-0.2	-0.9
Newly industrialized Asian economies	7.9	8.2	--	1.8	-1.0	-2.4
Developing countries	4.0	5.8	4.0	4.7	-0.3	-0.6
Africa	2.5	2.8	3.5	3.8	-0.3	-0.6
Developing Asia	6.1	6.8	5.6	5.9	-0.2	-0.3
China	7.1	8.0	7.3	7.1	-0.2	--
India	6.8	6.0	4.4	5.2	-0.1	-0.5
ASEAN-4[2]	2.8	5.0	2.2	3.4	-0.2	-0.8
Middle East, Malta, and Turkey	2.0	5.9	1.7	4.0	-0.6	-0.7
Western Hemisphere	0.1	4.1	1.1	2.1	-0.6	-1.5
Brazil	0.5	4.4	2.0	2.2	-0.2	-1.3
Memorandum						
Sub-Saharan Africa	2.5	2.9	3.2	3.7	-0.3	-0.5
Heavily indebted poor countries[3]	3.8	3.7	3.9	4.9	-0.5	-0.7
Countries in transition	3.6	6.3	4.7	4.0	0.7	-0.1
Central and eastern Europe	2.0	3.8	3.0	3.6	-0.4	-0.6
Commonwealth of Independent States and Mongolia	4.6	7.8	5.9	4.3	1.4	0.3
Russia	5.4	8.3	5.8	4.2	1.8	0.3
Excluding Russia	2.8	6.8	6.1	4.3	0.7	0.2
World trade volume (goods and services)	5.4	12.4	1.4	2.7	-1.4	-2.6
Commodity prices (in U.S. dollars)						
Oil[4]	37.5	56.9	-11.4	-16.0	-6.4	-7.4
Nonfuel (average based on world commodity export weights)	-7.0	1.8	-5.1	1.7	-2.5	-2.8
Consumer prices						
Advanced economies	1.4	2.3	2.4	1.4	-0.1	-0.3
Developing countries	6.8	5.9	6.0	5.3	--	0.2
Countries in transition	43.9	20.1	16.5	11.0	0.1	0.3
Six-month London interbank offered rate (LIBOR, percent)						
On U.S. dollar deposits	5.5	6.6	3.9	3.1	-0.2	-0.6
On Japanese yen deposits	0.2	0.3	0.2	0.1	--	--
On euro deposits	3.0	4.6	4.2	3.2	-0.2	-0.7
Memorandum						
World growth based on market exchange rates	3.0	3.9	1.3	1.3	-0.3	-1.2

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during September 17-October 16, 2001.
[1]Using updated purchasing-power-parity (PPP) weights, summarized in the Statistical Appendix, Table A.
[2]Includes Indonesia, Malaysia, the Philippines, and Thailand.
[3]The 42 countries eligible for HIPC assistance from the Fund's program for Highly Indebted Poor Countries for whom data is available.
[4]Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil. The average price of oil in U.S. dollars a barrel was $28.21 in 2000, the assumed price is $25.00 in 2001, and $21.00 in 2002.

Figure 2. Global Indicators[1]
(Annual percent change unless otherwise noted)

Global growth is projected to slow markedly in 2001–02, while inflation remains subdued.



[1]Shaded areas indicate IMF staff projections. Aggregates are computed on the basis of purchasing-power-parity weights unless otherwise indicated.

[2]Average growth rates for individual countries, aggregated using purchasing-power-parity weights; these shift over time in favor of faster growing countries, giving the line an upward trend.

[3]GDP-weighted average of the 10-year (or nearest maturity) government bond yields less inflation rates for the United States, Japan, Germany, France, Italy, the United Kingdom, and Canada. Excluding Italy prior to 1972.

- Among the **industrial economies**, the *United States* is now expected to experience a mild recession in the second half of 2001, followed by a recovery which strengthens through 2002, supported by the substantial macroeconomic stimulus in the pipeline, a gradual recovery of confidence, and the end of the inventory correction. As a result, real GDP growth in 2002 is now projected at 0.7 percent, 1.5 percentage points lower than projected earlier. Growth in *Canada* has been marked down significantly, in line with developments in the United States. Projections for the *euro area* have also been reduced, especially for *Germany*, reflecting recent data indicating a weaker-than-expected situation before the September 11 attacks as well as the aftermath while in the *United Kingdom* growth is expected to remain relatively resilient, buoyed by domestic demand growth and the easing of monetary policy. The outlook for *Japan* has become increasingly worrying, and the economy is now expected to experience two consecutive years of contraction for the first time in the post-war period.

- Among **emerging market countries**, the impact of recent events varies widely, depending on the structure of the economy and the strength of economic fundamentals:

    - For *the Western Hemisphere*, GDP growth in 2002 has been revised down by 1.5 percentage points to 2.1 percent, because of the deterioration in external financing conditions, which have seriously affected a number of countries in the region, and weaker external demand for goods, including the downturn in tourism, which has set back recovery in *Mexico* as well as many central American and Caribbean countries. Lower oil prices have further weakened the outlook for net oil exporters, while lessening the financing requirements of other countries.

    - In *emerging Asia*, growth is expected to remain reasonably robust in *China* and to a lesser extent *India*, which are less exposed to external developments. Elsewhere, notwithstanding increased policy stimulus and the generally beneficial effect of lower oil prices, growth has been marked down sharply owing to weakening external demand together with the further deterioration in the IT sector (which has particularly affected a number of the *newly industrialized economies*).

    - In the *Middle East, Malta and Turkey* region, growth will be adversely affected by lower oil prices, and in some cases weaker remittances and tourism revenues, reflecting both the fallout from the September 11 events and the worsened security situation in the region. In *Turkey*, the outlook has been affected by weaker external demand, especially for tourist services, and more difficult financing conditions, while domestic real interest rates remain extremely high.

    - In the *transition economies*, the impact of recent events is expected to be relatively moderate. Indeed, although slowing compared to 2000, growth in *Russia* has been revised upward for both 2001 and 2002, buoyed by relatively strong domestic demand. Growth in central and eastern Europe is also expected to remain reasonably resilient, partly owing to the benefits of lower oil prices.

- The **poorest countries** are being hurt by weaker external demand and commodity prices. While oil exporters are particularly affected, nonfuel commodity exporters are also suffering from further weakness in already depressed prices, especially for agricultural commodities, although the benefits from the lower cost of oil imports will help limit the increase in external financing requirements. On the macroeconomic side, while the outlook for individual countries varies widely, growth is projected to be relatively well sustained for the group as a whole—not least, because a number of countries are benefiting from the cessation of armed conflicts. However, this may understate the impact on poverty, as lower prices for agricultural goods will hurt rural areas, where most of the poor live, while the benefits of lower oil prices tend to accrue in urban areas.

With substantial policy stimulus in the pipeline, there is a possibility that recovery in 2002 will come more rapidly than presently expected. However, given the already difficult situation for the global economy, the major policy issue at the current juncture is clearly the possibility that a worse outcome could occur. In this context, I would focus on four key areas of risk:

- **Confidence and activity in the United States may pick up more slowly than presently expected**, for instance if the effects of the terrorist attacks themselves prove more prolonged, or if recovery is hampered by the imbalances accumulated in the past, including over-investment and consumers' relatively high indebtedness, particularly given higher interest rates for risky borrowers. In addition, there are downside risks to activity in the *other major currency areas*. With no major region providing substantive support to activity, further weakness in any one would reinforce the already synchronized downturn, with consequences that would be difficult to predict given the progressively stronger and more complex economic and financial linkages across countries. This could likely result in a greater and more prolonged withdrawal from risk taking in financial markets, as well as lower commodity prices, both of which would adversely affect *developing countries*.

- **The outlook for emerging market countries depends critically on how long global risk aversion remains elevated and bond issuance is basically limited to only high grade borrowers, as well as the extent of the squeeze generated by refinancing pressures in the meantime**. Recent declines in global interest rates have helped partly offset rises in emerging market spreads, and—with dedicated emerging market investors holding extremely large cash cushions—there is technical support for the market. However, bond markets—historically the largest source of external financing for emerging markets—are essentially closed for many countries, and financing pressures could become significantly larger and more widespread, particularly if the global outlook deteriorates further, or an unforeseen credit event in a major emerging market prolongs difficult market conditions.

- **The financial imbalances in the global economy remain an important source of risk.** Mature equity markets appear to be pricing in a relatively rapid recovery, and currency options market data suggest that expectations of a sharp depreciation in the U.S. dollar have not increased since the attack, partly reflecting a lack of confidence in financial markets of Europe's ability to decouple from the present slowdown in the United States. However, it remains unclear whether asset markets have fully priced in the deterioration in corporate credit quality and earnings prospects that has occurred thus far. An abrupt adjustment remains possible, particularly if the global growth outlook were to prove worse than expected, especially given the recent reduction in market liquidity—notably in the markets for credit swaps and derivatives—and the financial difficulties faced by some major market participants, including insurance companies.

- **Slowing growth and a flight to quality in financial markets would increase pressure on corporate and financial sectors across the globe.** This is of particular concern in Japan, where banks are highly exposed to developments in equity and bond markets, but may also become more important in other countries in Asia and Latin America.

The long-term influence of the terrorist attacks on the global economy is also difficult to determine. Productive potential could be reduced by higher "transactions" costs associated with greater uncertainty, such as greater spending on security, higher insurance premiums, and more stringent checks of traded goods. This reinforces the need to ensure that other barriers to trade are reduced through rapid progress towards a new trade round at the Ministerial meeting in Doha, which would also help lift confidence. That said, and while acknowledging the possibility of a lasting adverse impact on the global economy, I would align myself with the widespread view that the impact on long-term growth potential is likely to be reasonably small.

In summary, the global economy was already slowing prior to the events of September 11. The aftermath has led to a further deterioration in the short-term global outlook, added significantly to the difficulties faced by a number of emerging market countries, and will also have an adverse impact on the poor. Partly because of the strong policy response since the attacks, the economic effects may be reasonably brief, with recovery beginning around the middle of next year. However, major uncertainties and risks continue, and there remains a concern that a measurably worse outcome could occur—including significant further external financing pressures in emerging markets. As discussed in more detail in my October 5 statement, this underscores the need for policies among the major industrial countries, on which the outlook for global growth primarily depends, to be proactive; for emerging market and developing countries to support activity while recognizing that there will be little market tolerance for weak fundamentals; and, last but not least, for a coordinated and collaborative response by the international community, including the Fund.