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Recessions and Recoveries

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ASSUMPTIONS AND CONVENTIONS

A number of assumptions have been adopted for the projections presented in the *World Economic Outlook*. It has been assumed that real effective exchange rates will remain constant at their average levels during February 11–March 11, 2002, except for the currencies participating in the European exchange rate mechanism II (ERM II), which are assumed to remain constant in nominal terms relative to the euro; that established policies of national authorities will be maintained (for specific assumptions about fiscal and monetary policies in industrial countries, see Box A1); that the average price of oil will be $23.00 a barrel in 2002 and $22.00 a barrel in 2003, and remain unchanged in real terms over the medium term; that the six-month London interbank offered rate (LIBOR) on U.S. dollar deposits will average 2.8 percent in 2002 and 4.5 percent in 2003; that the three-month certificate of deposit rate in Japan will average 0.1 percent in 2002 and 2003; and that the three-month interbank deposit rate for the euro will average 3.7 percent in 2002 and 4.5 percent in 2003. These are, of course, working hypotheses rather than forecasts, and the uncertainties surrounding them add to the margin of error that would in any event be involved in the projections. The estimates and projections are based on statistical information available through early April 2002.

The following conventions have been used throughout the *World Economic Outlook*:

. . . to indicate that data are not available or not applicable;

— to indicate that the figure is zero or negligible;

– between years or months (for example, 1997–98 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years or months (for example, 1997/98) to indicate a fiscal or financial year.

"Billion" means a thousand million; "trillion" means a thousand billion.

"Basis points" refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point).

In figures and tables, shaded areas indicate IMF staff projections.

Minor discrepancies between sums of constituent figures and totals shown are due to rounding.

As used in this report, the term "country" does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

FURTHER INFORMATION AND DATA

This report on the *World Economic Outlook* is available in full on the IMF's Internet site, *www.imf.org*. Accompanying it on the website is a larger compilation of data from the WEO database than in the report itself, consisting of files containing the series most frequently requested by readers. These files may be downloaded for use in a variety of software packages.

Inquiries about the content of the *World Economic Outlook* and the WEO database should be sent by mail, electronic mail, or telefax (telephone inquiries cannot be accepted) to:

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PREFACE

The analysis and projections contained in the *World Economic Outlook* are integral elements of the IMF's surveillance of economic developments and policies in its member countries, developments in international financial markets, and the global economic system. The survey of prospects and policies is the product of a comprehensive interdepartmental review of world economic developments, which draws primarily on information the IMF staff gathers through its consultations with member countries. These consultations are carried out in particular by the IMF's area departments together with the Policy Development and Review Department, International Capital Markets Department, the Monetary and Exchange Affairs Department, and the Fiscal Affairs Department.

The analysis in this report has been coordinated in the Research Department under the general direction of Kenneth Rogoff, Economic Counsellor and Director of Research. The project has been directed by David Robinson, Senior Advisor of the Research Department, together with Tamim Bayoumi, Division Chief, World Economic Studies Division.

Primary contributors to this report also include Luis Catão, Hali Edison, Thomas Helbling, Maitland MacFarlan, James Morsink, Silvia Sgherri, Torsten Sløk, Marco Terrones, Stephen Tokarick, and Cathy Wright. Emily Conover, Toh Kuan, and Bennett Sutton provided research assistance. Nicholas Dopuch, Mandy Hemmati, Yutong Li, Di Rao, and Anthony G. Turner managed the database and the computer systems. Sylvia Brescia, Viktória Kiss, and Laura Leon were responsible for word processing. Other contributors include Michael Bordo, Robin Brooks, Ximena Cheetham, Jean Le Dem, Atish R. Ghosh, Benjamin Hunt, Aasim Husain, Mads Kieler, Manmohan Kumar, Timothy Lane, Prakash Loungani, Guy Meredith, Ashoka Mody, Carmen Reinhart, Ron van Rooden, Nikola Spatafora, and Raju Jan Singh. Marina Primorac of the External Relations Department edited the manuscript and coordinated production of the publication.

The analysis has benefited from comments and suggestions by staff from other IMF departments, as well as by Executive Directors following their discussion of the report on March 27 and 29, 2002. However, both projections and policy considerations are those of the IMF staff and should not be attributed to Executive Directors or to their national authorities.

FOREWORD

When the *World Economic Outlook* is issued, there is a natural tendency for outside commentators to concentrate on the material contained in Chapter I, which provides a comprehensive review of recent global developments, forecasts and risks, and current policy recommendations. While the global outlook is and will remain the central focus of the *World Economic Outlook*, there is much more to the *WEO* than that. The remaining chapters are more than just a supplement; they are intended to provide an in-depth—and sometimes provocative—look at a number of topical policy issues, of interest to policymakers and analysts alike. Work on these typically begins six months in advance of publication, a lead time that is necessary given the rigorous nature of these studies, not least the substantial amount of original empirical work that is required.

Back in October 2001, late in the planning stage of the current issue, it was not hard to decide that we needed to provide an in-depth look at the economics of recessions. Was the deep and widespread global slowdown of 2001 as unusual as many analysts were claiming? Was it so exceptional in the degree of synchronization across the major regions? Was the type of fixed investment–led downturn really more typical of nineteenth century recessions than of modern recessions? These are not merely academic questions, but rather essential to our understanding of the appropriate policy responses to the current conjuncture. Thus, the main analytical chapter of this *WEO* (Chapter III) is devoted to placing the current global slowdown in context.

Most existing studies of business cycles concentrate on individual countries, but the number of recessions per country is sufficiently small that it is hard to draw out any reliable regularities. Chapter III ambitiously sets out to look at all the "level" recessions (negative GDP growth) in 21 industrial countries over the period 1973–2001, 93 recessions in all! We also review a narrower range of countries to look at the history of national recessions going back to 1881. The results are startling, certainly compared to conventional wisdom.

(1) *First and foremost, synchronization is the norm historically.* The staggered global downturn of the 1990s was the exception, not the rule. Idiosyncratic shocks in the early 1990s—including the asset price bubble in Japan and consequences of German reunification—masked the usual forces that tend to coordinate recessions across the G-3 and beyond. What are the main forces underlying synchronization? Certainly, global linkages in trade and asset markets are important, and these have been growing over time since World War II, after having been curtailed during the two World Wars and the Great Depression. But common shocks are probably the single most important factor, at least across industrial countries. In the recent downturn, the bursting of the tech bubble was an international phenomenon. Other common factors included high oil prices and the simultaneous tightening of monetary policy toward the end of the long expansion.

(2) *Second, a sharp drop in business fixed investment is a typical precursor to a recession.* Indeed, in recent decades, investment contractions have been even more synchronized across countries than have the recessions. The role of fixed investment in recessions has actually increased over time, with virtually all recessions in recent decades accompanied by contractions in fixed investment, compared with only about 60 percent of recessions in the late nineteenth century.

(3) *Recoveries do not have to wait for a turnaround in fixed investment.* Rather, they typically start with a pickup in consumption and inventories. Indeed, over time, inventories have been less of a factor in the swings associated with business cycles, perhaps owing to better inventory management techniques.

(4) *Stock prices typically peak about one year before output,* and a fall of 25 percent is typical of recent experience.

(5) *Finally, increases in short-term interest rates have regularly marked the onset of recessions, and the recent downturn was no different.* Admittedly, it is not easy to sort out cause from effect: tight monetary policy may be needed to stem inflationary pressures toward the end of an expansion that would ultimately die out on its own.

So, while every recession has its own unique features, the recent global slowdown had much in common with past downturns, far more so than is commonly recognized.

Chapter II contains three shorter analytical essays. The first looks at why many countries in Latin America have had a disproportionate number of debt crises. The essay emphasizes three broad features of Latin American economies that seem to have heightened their vulnerability. First, most of the economies are relatively closed to trade, magnifying the costs of servicing external debt. As a result, even though Latin American external debt levels have not been high relative to GDP, they have often still been high relative to exports. Second, the region is subject to a high degree of macroeconomic volatility, stemming not only from terms of trade shocks, but also from volatility due to procyclical fiscal policy. Third, historically, much of the region has suffered from financial underdevelopment and, partly associated with that, low domestic saving. As a consequence, government borrowing is disproportionately external, and disproportionately denominated in foreign currency. The resulting currency mismatch between government assets and liabilities has all too often left countries in the region quite exposed to the effects of a sharp sudden exchange rate depreciation.

These three characteristics—high external borrowing, low exports, and volatile fiscal policy—have a common starting point: problems with tax systems and expenditure controls. A weak internal tax system forces a government to rely more heavily on tariff revenue, reducing the incentive to export, and resulting in relatively closed economies. Similarly, revenue shortfalls and expenditure excesses underpin the history of hyperinflation in the region, as governments are periodically forced to resort to monetary financing of deficits, particularly during periods of economic crisis or political instability. Even during periods of relatively low inflation, the specter of a return to high inflation has undoubtedly slowed the development of domestic financial markets in some countries. A history of high inflation similarly makes it difficult for governments to borrow at reasonable rates without offering to repay in foreign currency. Finally, a weak tax system and poor spending controls make it difficult to adopt countercyclical fiscal policy. Absent any sort of cushion from accumulated surpluses, the government is typically forced to tighten up rather than expand into a recession. As a result, shocks to a country's terms of trade are all too often amplified rather than mitigated by fiscal policy. Of course, the problem is extremely complex, but it is clear that the vulnerability of Latin American economies over recent decades was an outgrowth of many institutional and political considerations, and not simply the result of mistakes in macroeconomic management. As the essay notes, many countries in the region have made substantial progress in recent years, including better fiscal systems and more flexible exchange rate systems, so going forward the situation promises to be quite improved. Nevertheless, the essay provides a cautionary tale.

The second essay looks at the impact of the huge run-up in household wealth in industrial countries in the 1990s on consumer spending. Based on original empirical work, which builds on the existing literature, the essay finds that the impact is larger in market-based financial systems (where financial markets play the dominant role, as in the United States, the United Kingdom, and Canada) than in bank-based systems (where banks play the dominant role, as in Japan, Germany, France, and Italy). In the former, the dramatic rise in stock market wealth over the 1990s reduced the savings rate by 6 percentage points as of 2000—and by 8 percentage points if housing wealth is taken into account. By contrast, in countries with bank-based financial systems, the saving rate was little affected by the rise in stock market wealth, and the increase in housing prices reduced the saving rate by about 1½ percentage points. Not only has household wealth increased sharply, but the analysis also finds that consumption has become increasingly sensitive to stock market and housing prices. To the extent that changes in wealth affect inflation and output, then it must be the case that stock market and housing prices have become more significant considerations for monetary policy over the past decade, though it does not imply that monetary policy should directly target asset prices.

The third essay looks at the challenges to monetary policy in a low inflation era. It was not so long ago that most industrialized countries experienced sustained double-digit inflation. The essay argues that success in restoring low inflation in these countries owed much to widespread changes in the conduct of monetary policy, including institutional changes toward a more focused attitude on inflation, and the associated beneficial shifts in private sector behavior. These changes only came after economists and policymakers began to realize that the key to maintaining low inflation lies not simply in setting appropriate rules for monetary policy, but in properly designing central banking institutions. Enhanced central bank independence, transparency, various forms of inflation targeting, and choosing highly competent central bankers with solid anti-inflation credentials have all played a role in systematically bringing down inflation in many parts of the world. Good policies and, more important, good institutions—that make these policies sustainable—matter.

In the new low-inflation environment, central banks' objectives need to become more symmetric, as concerns about higher inflation have to be counterbalanced by concerns about deflation. Downward nominal rigidities of prices and wages make adjustment to deflation painful. If, in addition, inflation expectations are sluggish, then deflation puts a floor on how low the central bank can push real interest rates (in the short run), given that nominal interest rates cannot go below zero. As Chapter III on recessions shows, deflation was a major factor in recessions prior to World War I and the interwar period, but has largely been unknown in industrialized countries since World War II. Problems resulting from the ongoing deflation in Japan highlight the dangers and risks of allowing inflation to drift into negative territory. Concerns about deflation suggest that central banks need to be more proactive in responding to sharp downward shocks to activity. How high an inflation rate should the central bank target to reduce the danger of sustained deflation? The essay argues that the danger of getting into a deflationary spiral increases as inflation targets are lowered below 2 percent. Nevertheless, a slightly lower rate should be acceptable in a region with sufficiently flexible markets, provided the authorities are alert to any temporary drift into negative inflation territory, should one ever occur.

Kenneth Rogoff
Economic Counsellor and Director, Research Department