

Globalization and the World Economy: The Impact of September 11

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1. Introduction

Thank you Mr Chairman. Good morning, Ladies and Gentlemen.

It is a great pleasure to be here today – to address this distinguished audience, to be in Mexico again, and in Cancun for the first time. Mexico was a big part of my life during my first few years as First Deputy Managing Director of the IMF. The crisis of 1994 – described as the first financial crisis of the twenty-first century – was my very first major crisis. Unfortunately it was not the last – depending on how you count, there were between eight and ten more in the next seven years.

It is easy to forget how difficult, complicated, and confused was the situation in the early months of 1995, and how frequently during that year we wondered if and when Mexico would ever get back on track. So it is impressive to see how much progress has been made since then. The progress has continued during President Fox's first year in office and I would like to commend him and the economic team, including the Banco de Mexico, for the wise policies Mexico is pursuing in these difficult times. Lower inflation, fiscal restraint, the proposed tax reform, banking reform, a smaller current account deficit, and growing international reserves are all contributing to the confidence of investors and markets in Mexico's future, even at this difficult time.

Against that backdrop, we are gathered today at a time of serious uncertainty for the world economy and for Latin America in the wake of the tragic events of September 11. I will discuss their economic impacts. But we should emphasize that first and foremost, this is a human tragedy, for those affected directly by the terrorist acts themselves, and now also for those being caught up in the military response.

As to the economic impact: The attacks have dealt a further blow to an already weak world economy, as well as prompting greater volatility in financial markets. United States policymakers have responded vigorously and appropriately, but the environment for

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emerging market economies all over the world is less supportive than it was: the demand for their exports will be weaker and their supply of capital less reliable.

Given the importance of these events, I intend to interpret my topic – which was advertized as “Technology, the New Financial Architecture, Rich Countries, Poor Countries” – broadly. I will begin by talking about the implications of recent events for the world economy, then turn to the impact on Latin America, and finally to what this means for the process of globalization.

That might seem a long way from the theme of this conference – technology and its economic impacts. But it is not. Technology is an important underlying theme for several reasons. First, technological innovation and diffusion is one of the most important driving forces behind globalization, so in talking about globalization I will be talking about a critical consequence of technological change. Second, the economic impact of recent events comes on top of a global slowdown in which the bursting of the hi-tech bubble was an important component. Third, recent events will affect the willingness and ability of companies and countries to invest in new technology.

2. The World Economy

Let me turn first to the global picture.

The near-term outlook for the world economy was not good even before September 11. Synchronized growth slowdowns – and in the case of Japan a recession – were already under way in the US, Europe and Japan, while developing countries were facing weaker export demand and increasingly difficult financing conditions. The aftershocks from September 11 have darkened the picture, increasing the already significant downside risks to world growth.

Activity is suffering, in the US and elsewhere. Some industries have been hit very hard, notably airlines, tourism and insurance. Even so, the *direct* economic damage is likely to be relatively small, especially in relation to the size of the economy. Several commentators have drawn attention to the analogy with the effects of natural disasters – like the Kobe earthquake in Japan – that barely show up in the national accounts. But that analogy is misleading, because the uncertainty about the implications of the terrorist actions on September 11 for the future is much greater than the uncertainty about the implications an earthquake today has for the future of the economy. It is the *indirect* effects that will matter most, in particular, in the short-term much depends on the effects on consumer and investor confidence and spending, which were already under strain and have been strained further by the attacks.

Predicting how large these effects will be is very difficult, not least because they will depend on political and military developments yet to come. But it is important to remember that industrial country policymakers – especially in the United States – have already taken significant steps to loosen monetary and (in some cases) fiscal policy, and to underpin the

stability of financial systems by pumping in large amounts of liquidity. Given this aggressive response, the most likely outcome appears to be that the US will suffer a recession during the rest of this year, with a recovery taking hold early next year. In effect, the recovery we had expected to be taking place about now will be delayed for six months or so – but as a result of the aggressive policy easing, it is likely to be more vigorous when it does come.

This relatively benign view seems broadly consistent with what private sector forecasters have been saying. Since the attacks, the consensus forecast for US growth has dropped from 1.6 to 1 percent for this year and from 2.7 to 1.2 percent for next year. However growth during 2002 – that is growth fourth quarter 2002 over fourth quarter 2001 – is expected to be considerably more vigorous, at around 2.6 percent. And there could even be some upside potential on that number.

Activity in Japan will likely weaken further, unfortunately from a much lower base. The consensus growth forecast for next year has dropped from plus 0.5 percent to minus 0.4 percent since the attacks. Europe too will suffer, but probably somewhat less. Among the developing nations, the biggest hits are likely to be taken here in Latin America (both because trade will decline, and because capital will be harder to come by) and in emerging Asia (which is especially susceptible to weaker world demand), except China. Other regions will also be affected. For example, Sub-Saharan Africa will be hurt as commodity prices decline alongside industrial country growth.

This slowdown will be painful. There has been a lot of interest in whether for the first time in many years we are likely to suffer a world recession. One difficulty in answering that question is that we do not have an agreed definition of a global recession. But some forecasters are claiming that global GDP could decline in both the third and fourth quarters, which they would regard as a global recession. Most likely, global growth in the present growth slowdown will be around the level of 1991 but better than in 1981-82.

While this looks the most likely outcome, the distribution of forecasts at present tends to be bimodal – that is there are some who are quite pessimistic and some who are more optimistic, with relatively few in the middle. There is of course a risk of a more severe downturn than that of a decade ago. We *could* see a deeper and more sustained decline in confidence and activity in the industrial world, during which financing flows to some emerging market countries could all but dry up. In this scenario, there would be a deeper recession in the US, with recovery delayed until the second half of next year, and a particularly difficult period for Japan.

As I mentioned earlier, predicting the implications of September 11 is complicated by the fact that the attacks came at a time of increasing uncertainty about the long-term implications of the IT revolution. There was a major debate about the impact of the IT revolution on long-term productivity growth even in the United States. As the nineties wore on, confidence grew that there had been a permanent boost to the rate of productivity growth. Over a year has now passed since the growth rate of output began to decline, and with it estimates of the

growth rate of potential output. But all estimates still imply that potential output growth in the United States is significantly higher – and most likely in large part as a result of the IT revolution – than it was estimated to be a decade ago.

Improvements in IT have also had important impacts on productivity growth in Canada and Europe. And despite the current high-tech slump in some regions, IT has the potential to raise productivity and productivity growth in many other countries around the globe as the technology diffuses and as economic activities are reorganized. For this to happen, government policy and the investment climate will have to be welcoming of innovation and restructuring.

Returning to the cyclical situation: Monetary and fiscal stimulus is already in the pipeline, and there remains scope for further stimulus should that be needed. While Japanese monetary policy cannot really reduce short-term interest rates any further, it could become more aggressive by purchasing more long-term government debt. In the euro area too there is scope for further monetary easing, and also to allow the automatic stabilisers to work in fiscal policy. In both Japan and the euro area, stepping up structural reform to boost long-term growth prospects is more important now than ever.

Emerging market and developing countries generally have less room for maneuver. It is often remarked how difficult it is for emerging market countries that they cannot engage in Keynesian countercyclical policies when hit by an external shock. I believe that in the longer term, countries need to develop room for countercyclical policies by reducing their debts and budget deficits to much lower levels, so that there is no danger to fiscal sustainability if they do want to use more active policies when necessary – this is very much the idea behind the European stability pact, except that the debt limits for emerging market countries should be lower than the Maastricht 60 percent, and possibly other parameters would also need to be adjusted to reflect the greater volatility of emerging markets. At present, the key objective must be to maintain course on prudent macroeconomic policies and thereby safeguard the gains in policy credibility that have been earned in recent years. It is especially important to persist with structural reforms, to boost long-term growth prospects and also to support investor and creditor confidence in a very uncertain environment.

If the slowdown does prove particularly deep or prolonged, then it is possible that more countries will face serious financial difficulties and will have to go to the Fund for help. That of course is one of the key purposes of the Fund: to help countries pursuing good policies confront temporary difficulties – including through the provision of precautionary arrangements, possibly for countries that qualify, the Contingent Credit Line.

3. Latin America

Let me now turn to Latin America.

Prior to September 11, the outlook for Latin America was already clouded by the global slowdown and spillover effects from the difficulties in Argentina. The IMF expected growth in the region to have dropped from 4.2 percent last year to 1.7 percent this year, before picking up again to 3.6 percent in 2002. The outlook has clearly deteriorated since then. The impact of September 11 will make itself felt mainly through three channels: the impact on US and global growth, the effect on oil prices, and the rise in investors' risk aversion.

The weakening of US growth will hit Mexico hardest, because of its strong trading links with the US. The Caribbean, Central America, will suffer particularly from declines in tourism and remittances from workers living in the US.

The outlook for oil prices, and therefore its economic impact, is unclear. Military action could push prices higher, while reduced demand, especially from the airline industry, could push them lower. It is too early to tell which effect will predominate, and thus to know which countries will be adversely affected. Higher oil prices would hurt Brazil, Chile, and most of the smaller and poorer countries, while lower prices would weaken the fiscal and current account positions of Venezuela, Mexico, Ecuador and Columbia. Argentina's balance of payments, interestingly, would benefit slightly from an increase in energy prices.

Latin American financial markets have been affected by the increase in investor risk aversion, which is reflected in emerging market bond spreads. In the wake of the attacks, indicators of risk aversion reached their highest levels since the Russian crisis of August 1998. This was reflected in financial markets across the region: regional equity markets have declined, bond spreads have risen, and currencies have come under pressure. These trends have weakened an already fragile financial environment and left countries more vulnerable to financing and indebtedness problems. Depending on how rapidly global growth returns, and on developments in emerging markets, we need also to consider the possibility that financial flows to some countries could be cut off for some time, as happened at the end of 1998.

At the same time as average bond spreads have risen, we should also note that the financial markets seem to be differentiating better among countries. In Latin America the greatest pressures are evident in Argentina, which has important contagion effects on Brazil, and also effects on the exchange rate in Chile. A few weeks ago contagion effects in Latin America seemed more widespread.

These strains are taking place against a backdrop of important policy improvements in most Latin American countries over recent years. But more will clearly have to be done. External volatility makes it all the more important that countries in the region step up fiscal consolidation, target low inflation, and implement pro-growth structural reforms – especially public sector and labor market reform. The more experience there is with the volatility of capital flows to emerging market countries, the clearer it is that countries with open capital

accounts have to be sure that they are not excessively exposed to these fluctuations, which means making sure not to borrow too much when the markets are friendly.

Social and poverty indicators may also be affected by the current situation. It is important that authorities do what they can to ensure that social tensions are minimized and that policy implementation is not hampered, particularly against the Latin American background in which inequalities are particularly pronounced.

These are important challenges, but not insuperable ones. And the region can also rely on the support of the international community, including from the IMF and the other multilaterals.

4. Globalization

Finally, let me turn to the implications for globalization.

A number of commentators have predicted in recent weeks that the attacks on the World Trade Center could bring an end to globalization. For example, Stephen Roach of Morgan Stanley wrote recently in the FT: “The footprints of globalization have left an obvious and important mark on the economic landscape during the last decade. But the terrorist attacks of September 11 and their aftermath may bring about its demise.”

I am not that pessimistic. But Mr Roach and the other authors make a valuable point – that globalization is neither unstoppable nor irreversible. Globalization has been driven by three forces: technology, which has increased the speed and reduced the cost of crossborder flows; changing tastes, in which people and firms have become increasingly willing to take advantage of these flows; and public policy, which has by and large lowered barriers to international transactions, for example in trade. We can be sure that technological progress will continue to work in favor of globalization, but the impetus from the other two factors could in principle slow or reverse.

Mr Roach bases his argument on the reaction of the private sector to the recent events. He argues that September 11 will make cross border flows more difficult and more expensive, for example by increasing the cost of transportation of goods and people, and the costs of insurance. It will also, as we have already seen, raise global risk premia. Taken together, these in effect impose a tax on globalization, one which might be exacerbated if higher defence spending crowds out private sector activity.

There is something to this, but it is hard to see how the effect can be so large as to bring globalization to an end, or to do more than slow the process for a short while. The power of advancing technology, particularly communications technology and the internet, and the perpetual human drive to take advantage of such improvements, will soon overcome an increase in transactions costs of the magnitude described by Mr. Roach.

John Gray, a professor at the London School of Economics, has made a stronger claim. He argues that the demise of globalization is not only inevitable but also desirable. But he

caricatures the process as an attempt to impose laissez-faire market liberalism on parts of the world where it is not wanted and it is not needed. “There was only one route to modernity – and the seers who ruled the IMF were resolved that it be followed everywhere”, he has argued.

This is simply not so. In recent decades globalization has been *embraced* rather than *imposed*, because it delivers the goods – literally. Take trade, as just one example. The World Bank recently completed a study that classified developing countries according to the degree to which they increased trade relative to income since 1980. The top third – the “new globalizers” – lowered import tariffs by a third and achieved per capita GDP growth of 3.5 percent in the 80s and 5 percent in the 90s. These countries saw the share of trade in GDP double in those two decades. By contrast, the rest lowered tariffs only 10 percent and saw per capita GDP fall. The data also show that in the past two decades, developing country exports have shifted from being 20 percent manufactured goods to 80 percent manufactured goods – a truly extraordinary change.

The evidence is clear. Countries that integrate into the global economy, taking advantage of the opportunities for trade, do best. And, provided they open up to international capital flows carefully, with a sufficiently strong financial sector and sound macroeconomic framework in place, they benefit too from integration into the global financial markets. This story does not need to be emphasized in Mexico, which has benefitted so much from NAFTA, and in recent years, as it has strengthened its macroeconomic policies and financial system, from its access to the global capital markets, including for foreign direct investment.

Of course, globalization means change – and change always brings with it costs and risks. Those who are adversely affected by globalization should be helped to adjust. Further, there has been an increase in inequality in many countries during the last few decades. But that seems to have more to do with the nature of technical change – which is rewarding those with more skills – than with globalization per se. Over a longer period, globalization is sometimes blamed for the rise in global inequality over the last two centuries. But as Lindert and Williamson argued in recent NBER working paper: “Globalization probably mitigated rising inequality between participating nations. The nations that gained the most from globalization are the poor ones that changed their policies to exploit it, while the ones that gained the least did not, or were too isolated to do so.”

The key task for the IMF and other international financial institutions in the coming decades is to help countries develop policies that will enable them to make the most of globalization, while minimizing its costs. That means policies that will help economies adapt, and – just as important – policies that will help people adapt, for example, strengthening health, education and social safety nets.

This help will be offered but not imposed. Professor Gray makes exactly this point: “Rules on trade and the movement of capital should be left to multilateral agreements between sovereign states”, he says. “If countries opt to stay out of global markets, they should be left in peace. They should be free to find their own version of modernity, or not to modernise at

all”. That is how the world is, most obviously in the WTO, but also in the IMF – where even after 57 years there remain a few countries that have still not accepted the obligations of Article VIII of the IMF charter, which is to maintain convertibility of the currency for current account transactions.

Another cost of globalization that has been all too apparent in recent years has been the greater frequency and severity of financial crises. This is a topic with which we are now all very familiar. So let me simply note in passing that the Fund has taken important steps since the Mexican crisis of 1994 in improving crisis prevention and crisis management. In crisis prevention, we have strengthened our surveillance of economic policies, financial sectors, and international markets, as well as offering precautionary credit lines to countries with good policies that fear being caught in the backwash from crises elsewhere. The Contingent Credit Line facility could be useful to several countries in the current uncertain environment. For crisis management, the Fund has put in place the SRF, the Supplemental Reserve Facility, which that allows us to lend on appropriate terms to countries facing a pervasive loss of investor confidence, provided of course that they adjust their policies to deal with the underlying causes of the crisis. At the same time, we are seeking to do more to ensure that private sector creditors contribute to effective crisis resolution.

The bottom line is that the events of September 11 make it more important to help countries benefit from globalization, not to shut them out. The international financial institutions have an important role to play. At the end of the days, these institutions are agents of the international community – working together for the mutual benefit of their members. It is gratifying to see that the response to last month’s tragic events has generally taken the form of greater international cooperation, rather than a retreat into isolation. Let us hope that this spirit continues to prevail, for example in a revival of the push for trade liberalization at the forthcoming WTO meeting – wherever it is held.