WEO Press Conference Speaking Note—September 26, 2001

In my new role as the IMF's chief economist, this is my first turn in presenting the *World Economic Outlook*. The man I have replaced, Michael Mussa, served in this role as both a stellar economic analyst and a prescient forecaster of the global economy. The WEO's record is an enviable one, which I aspire to maintain in the coming years. I am fortunate that Mr. Mussa leaves behind a superb team in the Research Department of the International Monetary Fund, and that in producing this document, we have enjoyed superb cooperation and support from everywhere in the Fund.

Since the IMF's last *World Economic Outlook* in April, prospects for the global economy have continued to weaken. Our latest round of quantitative projections, presented in the new *WEO* we are publishing today, were completed just before the tragic events of September 11. The implications of the terrorist attack go well beyond the economic sphere, but it clearly took place at a difficult time for the global economy. The WEO projections were already showing markdowns in activity in almost all regions of the world. However, given the strong macroeconomic policy response we have seen since April, and given the gradual abatement of the earlier oil price shock, these projections do envision a gradual recovery toward the end of the year.

A central question, of course, is how these projections might be interpreted in light of September 11 and its aftermath. There is no doubt that the attack is having a negative effect on activity now in many regions of the globe, and that it has increased what were already significant downside risks to the short-term global outlook, including for emerging market economies. However, it is important to put the current economic situation in perspective.

While there are clearly substantial uncertainties about unfolding events, one should not overlook that the economic fundamentals in many countries have in many respects improved in recent years and, from an economic perspective, this leaves the world somewhat less vulnerable than it might otherwise be. These improvements, together with the aggressive response by central banks across the globe, should help reduce the risk of sustained reductions in consumer and business confidence, a key concern in the months ahead. In the remainder of my remarks, I will elaborate on these issues.

Even prior to September 11, macroeconomic developments over the past six months already pointed to weaker growth in just about every region of the globe, both this year and next, than we anticipated in April. Among other factors, this synchronized slowdown has reflected stronger than expected global linkages (discussed in Chapter 2 of this WEO), which have been particularly evident in Europe; the continued weakness in the IT sector; the deteriorating situation in Japan; and worsening financing conditions for emerging markets. Consequently, our published global growth projection for 2001 has been marked down by a little over a half percentage point to 2.6 percent, with a similar reduction in the outlook for 2002.

How is this assessment changed by the attack? There has certainly been a substantial initial impact in financial markets, although experience suggests that financial markets can over-react to such shocks initially. Over the past two weeks, major stock market indices in the U.S. and Europe have fallen 8-12 percent, and in Japan by 5 percent. Many emerging stock markets have fared even worse, particularly in Latin America and East Asia. There has also been a broad-based flight to quality reflected in a sharp rise in spreads for both highyield and emerging-market bonds. Oil prices, after rising immediately after the attacks, have since fallen back sharply to levels significantly below those prevailing on September 10. Movements in the major currencies have been relatively moderate, with the U.S. dollar weakening slightly against the euro and the yen.

I can only add my voice to those who have commended national regulators, financial authorities and market participants for showing that the global financial system can continue to function smoothly even under a difficult and totally unanticipated form of extreme duress. Monetary policy in the major economies has responded aggressively to support the global payments system and to strengthen confidence and activity. The monetary authorities in the U.S., the euro area, Japan, Switzerland, Canada, and the U.K. directly injected large amounts of liquidity. The Fed also entered into temporary swap arrangements with the ECB, the Bank of England, and the Bank of Canada to facilitate the functioning of financial markets and to provide liquidity in U.S. dollars. In addition, the Fed moved to cut interest rates by 50 basis points last week, quickly followed by cuts of the same magnitude by the Bank of Canada, and then the ECB and the Swiss National Bank. Subsequently, the Bank of England and the Bank of Japan also cut rates, as did the monetary authorities in a number of other economies, including Denmark, Sweden, New Zealand, Hong Kong SAR and Korea. In the United States, additional fiscal appropriations for defense, reconstruction, and the airlines will also provide support to activity.

Abstracting from uncertainties surrounding the possibility of further conflict, what is the likely direct economic impact of the events of September 11? The attack has taken a terrible toll in human lives, but the *direct* economic damage —in relation to the overall United States economy— is still relatively moderate, even though certain industries have been hard hit, particularly airlines, insurance, and tourism. While it is difficult to find close parallels in recent history, the direct damage is much smaller than that resulting from the Kobe earthquake of January 1995, which, as it turned out, had only a very limited impact on output growth in Japan. Now, of course, the potential *indirect* effects of the attacks—on consumer sentiment and spending, on business confidence, and on risk aversion—are likely to be significantly more important. These are much more difficult to assess, and will depend importantly on how non-economic events evolve in the aftermath of the attack.

On the economic front, there are a number of reasons for cautious optimism. First, there is now a sizable amount of policy stimulus in the pipeline in most major economies, even more than we had anticipated a few weeks ago. Second, economic fundamentals across the globe are considerably stronger than they were a few years ago, reflected in lower inflation; stronger fiscal positions; greater monetary policy credibility; and, in many emerging markets, more flexible exchange rate regimes and lower external vulnerabilities. And third, the terrorist attack should not substantially affect underlying productivity growth in the U.S. economy, on which economic prosperity ultimately depends – and here I refer you to the discussion of the IT revolution in Chapter 3 of this *WEO*.

With the situation remaining fluid, it is premature to try and quantify the implications of the attack for growth in the United States and elsewhere. There will clearly be a short-term effect on activity, particularly in the last part of this year, both in the United States and in other countries. However, there is still a reasonable prospect that a recovery will begin in the first half of next year. In terms of the projections in the *WEO*, the effect on projected global growth in 2001 is likely to be moderate, since developments in the third and fourth quarters of the year have a limited impact on the average growth rate for the year as a whole. In 2002, however, global growth is likely to be rather lower than the 3.5 percent presently projected.

In sum, the downside risks identified in the main text of this *World Economic Outlook* have now increased, even if the economic channels are largely the same. The task for policymakers has correspondingly become more challenging, both in advanced and in developing countries. The basic requirements remain those set out in the *WEO*, but let me highlight just three points:

- The aggressive monetary policy response following the attack has been appropriate, and there remains room for maneuver, to varying extents, if additional action is needed. In particular, there remains room for a more aggressive monetary easing in Japan, even following the welcome steps last week. On the fiscal side, the automatic stabilizers should be allowed to operate. Beyond that, it is probably best to wait a little to see how events develop; frantic, ill-focused, actions to stimulate the economy risk being counterproductive.

- Given the uncertainties in the United States, other countries—notably in Europe and Japan—will have to rely more on internally generated growth. This makes it even more important to press ahead with structural reforms.

- The weaker global outlook has clearly added to the difficulties facing emerging market countries. With markets increasingly differentiating according to policy performance, the central requirement remains to stay the course of prudent macroeconomic policies and structural reforms.