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Downward Revisions to "World Economic Outlook" and Downside Risks

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On September 20, the International Monetary Fund released the latest version of its "World Economic Outlook (WEO)". The WEO, revised every quarter, is positioned as a reference standard regarding present and future conditions of the world economy.

The latest version, as expected earlier, made a substantial downward revision to the world economic growth projection. The world economy is now projected to grow 4.0% both in 2011 and 2012. The projected growth rate is not necessarily low, but is down 0.3 percentage point from the previous projection given in June for 2011 and down 0.5 point for 2012. Growth projections for major countries have been lowered. Particularly, substantial downward revisions have come to U.S. and European growth projections.

U.S. economic growth is now projected at 1.5% for 2011, down 1.0 point from the previous forecast, and 1.8% for 2012, down 0.9 point. For Europe (the euro area), economic growth is forecast at 1.6% for 2011, down 0.4 point, and 1.1% for 2012, down 0.6 point. The IMF has thus made substantial downward revisions to European and U.S. growth projections, leading to a downward revision for global economy.

It may be needless to say that factors behind the downward revisions include various problems surfacing in the European and U.S. economies since August and serious relevant fears about the future course of the world economy. In the United States, turmoil over whether to raise the federal debt ceiling in early August triggered a chain of negative reactions including a major debt rating agency's downgrade of the U.S. government bonds rating, a decline in confidence in the U.S. dollar as a key currency, and a New York stock market fall, aggravating fears about the future U.S. economy. Market players are concerned that the U.S. economy could suffer another dip after managing to recover from a recession following the September 2008 Lehman Shock.

In a sense, the European economy may be in a more serious situation. The resurging Greek debt crisis has led to growing fears of default on Greek government bonds, casting a dark cloud over the future of the euro area economy. As the other euro area countries and the European Central Bank have decided to implement provision of additional financial assistance to Greece in October, the market has seemingly recovered stability at the moment. But many analysts still deny an end to the Greek default crisis, as it is uncertain whether Greece could implement austere budget and economic measures as a precondition for the additional aid to achieve the fiscal consolidation targets. Furthermore, discussions on the Greek problem have highlighted various contradictions and vulnerabilities as fundamental problems regarding the euro economy integration. Under the common currency of the euro, monetary policy discretions to meet national conditions are restricted. It is growing politically difficult for major euro-area countries to expand financial support for Greece and other weaker nations at the cost of taxpayers' money under their respective severe economic and fiscal situations. Particularly, it is uncertain how Germany as the center of the euro-area economy would try to defend the euro economy.

Present prescriptions are seemingly based on scenarios where emergency loans are combined with an austere budget policy to overcome a crisis. But market developments are unpredictable. The Greek problem could affect other European countries with sovereign debt problems and banks holding Greek government bonds, spilling over to the entire euro area and even the entire world economy. Some countries could choose to secede from the euro area in the face of debt crises. Ultimately, downside risks exist to severely shake the entire euro area.

We must pay attention to an indication that a basic condition for the above IMF outlook is policy management to avoid the worst scenarios for the euro area and U.S. economies. If downside risks emerge in Europe or the United States, the IMF may have to substantially revise economic growth projections downward again. The IMF itself is not necessarily optimistic, as indicated by its title of a chapter in its latest report: "Risks Are Clearly to the Downside." The report calls for keeping close watch on future developments.

As a matter of course, the future course of the world economy is a variable exerting great influences on the supply/demand balance and prices in the international energy market. As for the energy supply/demand balance, the International Energy Agency has adopted the IMF outlook as a key basic condition for working out a world oil demand outlook in its monthly oil market report. In this sense, the latest downward revisions to growth projections (and possible future downward revisions) are expected to considerably affect the world oil demand outlook. In addition to the abovementioned influences on the energy supply/demand balance, the WEO revisions could exert financial impacts on energy prices, particularly crude oil prices, by affecting stock and currency markets and risk tolerance in overall financial markets. The benchmark West Texas Intermediate crude oil futures price, now in an $85-90/barrel range (with the Brent crude futures price at around $110/barrel), could deviate substantially from the present range depending on future world economy developments, particularly the emergence of serious downside risks. In anticipating the future energy market, we may have to keep close watch on risk problems in the world economy, particularly the European and U.S. economies.

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