Last updated: October 9, 2012 4:47 am

IMF cuts global growth forecasts

By Claire Jones in Tokyo

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The failure of US and eurozone policy makers to tackle their fiscal woes is threatening an already "slow and bumpy" global economic recovery, the International Monetary Fund has warned.

In its World Economic Outlook, the IMF downgraded its forecasts for global growth next year and provided ammunition to critics of austerity, concluding that governments had systematically underestimated the damage done to growth by tax rises and spending cuts.

The IMF now believes economic output will expand by 3.6 per cent in 2013, down from its July estimate of 3.9 per cent. But this assumes the US Congress will take action to avoid the "fiscal cliff" – the automatic expiry of tax cuts and introduction of spending reductions next year – and that eurozone governments will follow the European Central Bank's plan to buy sovereign debt by committing to economic reform and closer integration.

"A key issue is whether the global economy is just hitting another bout of turbulence in what was always expected to be a slow and bumpy recovery or whether the current slowdown has a more lasting component," the IMF said. "The answer depends on whether European and US policy makers can deal proactively with their major short-term economic challenges."

Economic uncertainty would continue to weigh on output in both advanced and emerging markets, the fund added, though it remained comparatively upbeat on the outlook for China.

Growth estimates for China for this year and next were revised downwards by a fifth of a percentage point to 7.8 per cent and 8.2 per cent respectively, but the IMF believed there would be a soft landing for the world's second-largest economy, along with the rest of the region. "The outlook is for a modest pick-up in growth on the back of recent policy easing," the IMF said.

The IMF slashed its forecast for the UK economy this year from growth of 0.2 per cent to a contraction of 0.4 per cent. The fund now expects growth of 1.1 per cent next year, down from an estimate of 1.4 per cent. The new forecasts are broadly in line with those of private sector economists.

The fund points to new analysis showing that governments' assumptions about the trade-off between fiscal consolidation and growth had been too favourable, and cutbacks would do more damage to output than their economic forecasts predicted.

The IMF said that evidence from 28 countries shows that so-called fiscal multipliers, used by governments to assess the impact on growth of fiscal cutbacks, have underestimated the damage to the economy. "The multipliers used in generating growth forecasts have been systematically too low since the start of the great recession," the IMF said. A smaller multiplier implies fiscal consolidation is less costly.

Olivier Blanchard, chief economist, indicated on Tuesday that the analysis had influenced the Fund's policy prescriptions for countries under IMF programmes. Mr Blanchard cited the troika's recent relaxation of Portugal's deficit target for 2013 to 4.5 per cent of gross domestic product from 3 per cent, saying: "When the case is fair, we have to get ready to adjust targets given that fiscal multipliers are so large."

According to the IMF, policy documents seen by fund officials suggest that governments are commonly using fiscal multipliers of about 0.5 to calculate the impact of austerity on growth. A multiplier of 0.5 would mean that for every $1 lost in government spending, 50 cents is wiped from output.

"Our results indicate that multipliers have actually been in the 0.9 to 1.7 range since the great recession," the fund said.

Mr Blanchard said fiscal multipliers were substantially larger than usual because the impact of fiscal cutbacks could not be offset by looser monetary policy. "We are in a period where many countries are in a liquidity trap and monetary policy is much more constrained than in normal times," he said.

The chief economist said Spain and Italy should receive financial assistance in the form of direct bank recapitalisations and lower borrowing costs, once they followed through with adjustment plans.

The IMF called for the European Stability Mechanism, the eurozone's permanent bailout fund, to be made operational as soon as possible to inject capital directly into banks based in the periphery. Funds to ensure sovereigns could borrow "at reasonable cost" could be channelled through either the ESM or the European Financial Stability Facility, the bloc's temporary rescue vehicle.