Deflation, production cuts and currency turmoil, a sign of things to come

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The last week in May was a bad one for world capitalism, and could well signal the start of many worse days to come.

The week opened with a fall of 150 points on Wall Street amid fears that the impact of the Asian meltdown was far from over. Then came the crisis in Russia. On Wednesday the central bank raised overnight interest rates to 150 percent to stem a run on the rouble. The week concluded with the announcement in Japan that unemployment had reached a post-war record of 4.1 percent. Almost 1 million workers lost their jobs in April.

The Japanese jobless figures, coupled with other economic data saw the value of the yen fall to 139 to the US dollar — its lowest level for seven years. A labour ministry spokesman described the unemployment rate as “very severe”, amid warnings that it could soon reach 5 percent.

The record jobless figures point to the emergence of a deflationary contraction. Japan is in the grip of a downward spiral of production cuts, inventory adjustments and reductions in capital spending; leading to further sackings, declining consumer confidence and spending, resulting in further production cuts.

Retail sales for April were down 0.5 percent for the year and 2.1 percent over the previous month. Inventories — unsold stocks — reached their highest levels for 25 years, despite a 1.1 percent cut in industrial production over the previous month, and a 6.2 percent reduction over the previous year.

There were further danger signs for the banking system with the decision by Moody’s Investor Services to downgrade the credit rating of the Bank of Tokyo-Mitsubishi and four other banks, amid indications that it could lower the rating of four more.

Moody’s said the continuing stagnation of the economy, the bad loans in Asia and the problems arising from reckless lending during the period of the “bubble economy” in the late 1980s may be too much for some banks.

“The combined scale of these problems may overwhelm many banks’ internal resources and necessitate substantial official assistance,” it said. In other words, Japanese banks may start to collapse under the weight of bad debts and require government action to prop them up.

Major banks are experiencing their worst earnings ever and in the financial year to the end of March the top 19 banks wrote off bad loans totalling 10.7 trillion yen, or $US80 billion. Some analysts warn that only three of the top 20 banks may survive the crisis.

Global financial institutions are predicting that the situation in Japan can only get worse. According to Stephen Roach, chief economist for Morgan Stanley: “In my conversations with literally hundreds of institutional investors about Japan over the past several weeks, one point comes through loud and clear: Investors are virtually unanimous in their bearishness. In fact, in all my years in this business, I have never come across such unanimity on a market, a country or a concept.”

Long-time Japan observer Dr Kenneth Courtis of the Deutsche Bank warned: “This crisis in Japan is monumental, and that creates monumental problems for the rest of Asia.”

Asian recession deepens

The fall in the value of the yen is undercutting exports from other Asian countries, adding to the regional recession.

The Korean economy, which will be the most adversely affected by a sudden yen devaluation, experienced a 4.8 percent contraction in the first quarter of this year. Industrial production in April fell by 10.8 percent — the biggest decline since records were first compiled in 1954 — following a 10.1 percent decline in March.

Consumer demand was down by 10.5 percent and imports by 25 percent. The Korean stock market, which has almost halved since March, hit an 11-year low. Despite the IMF bailout and a rollover of foreign debts, the Korean financial system is still in a precarious situation. Banks are holding $85 billion in problems loans, credit is scarce and many small companies are going bankrupt.

Fearful of a financial crash, the government is backing efforts to save the construction-based Dong Ah Group, the country’s 10th biggest chaebol, which is struggling under debts of $3.5 billion — equivalent to its entire annual revenue. The chairman of the government financial supervisory commission overseeing financial reform said the failure of the group would “cause the collapse of the financial system.”

Up until now Hong Kong and Malaysia seemed to have escaped some of the more far-reaching effects of the financial crisis. That impression was dispelled with the release of new economic statistics.

Hong Kong recorded a 2 percent fall in Gross Domestic Product for the first quarter of the year — the first decline in 13 years. Unemployment stands at 3.9 percent — the highest for 14 years —

and the economy is certain to record another quarter of negative growth, moving into an official recession.

Hong Kong financial secretary Donald Tsang, who only days ago was predicting a 3.5 percent growth rate for the year, said that was now unattainable and that he had "never experienced a situation as volatile as this over my 30 years as a public servant."

In Malaysia, the central bank announced on Saturday that GDP had fallen by 1.8 percent in the first quarter, putting in doubt predictions of a 2 percent growth rate for 1998. The manufacturing sector fell by 2.4 percent and construction slumped 10 percent.

Across the border in Thailand, where it is predicted GDP will fall by 7 percent for 1998, the manufacturing index for March fell by 21 percent compared to a year ago, while the investment index was down 9 percent.

The financial crisis continues to have its sharpest impact in Indonesia. Moody's reported that Indonesia "is now faced with a broadly insolvent banking system" with up to 75 percent of loans classified as non-performing.

The International Monetary Fund's Asia office chief Hubert Neiss has acknowledged that the contraction in the Indonesian economy will be at least 10 percent, shattering earlier IMF predictions of positive growth rates. Some forecasts put the contraction at 20 percent, with predictions that inflation could go as high as 700 percent over the next three months.

This means that the marginal increases in living standards recorded over the past decade and a half, which were used to proclaim an "Asian miracle", are being wiped out virtually overnight.

Russian breakdown

But perhaps the most ominous signs for the stability of world capitalism were the events in Russia.

Barely a week after US Treasury Secretary Robert Rubin had urged the House of Representatives to provide additional funds to the IMF, warning that it would otherwise not be able to meet another Asian crisis, Russian financial markets were in turmoil.

The immediate cause of the crisis was the failure of the $2.1 billion Rosneft oil privatisation to attract a bidder. Oil prices have fallen from a high of $25 per barrel in January 1997 to about $14 for the North Sea Brent blend, with Russian oil selling for a discount of around $1.30 on the Brent price.

With the tripling of interest rates and a pledge of loan funds from the IMF, the immediate crisis abated ... at least for the time being. But stopgap measures are not enough, as the editorial in the London-based *Financial Times* last Saturday made clear:

"If the issue in Russia were simply one of confidence then perhaps the interest rate hike, and yesterday's statement of support from the International Monetary Fund, would be enough to alleviate the crisis. But Russia also has serious cashflow problems. The government has a rouble debt of $60bn, much of which is short-term, and high interest rates mean the cost of borrowing has soared. Foreign currency reserves are only $14.5bn, not enough to protect the rouble against a large-scale outflow of foreign capital: foreigners hold around $20bn of Russia's rouble debt and the government has around $140bn of foreign-currency debt. To cap this, Moody's yesterday downgraded Russia's credit rating, making borrowing more difficult."

Structural problems

Confronted with the deepening global impact of the Asian crisis various economic commentators and pundits are being forced to recognise that it is rooted in structural problems.

Writing in the *Sydney Morning Herald* Max Walsh took issue last week with a group of Australian National University academics who claimed that the Asian crisis was primarily a "financial adjustment". He insisted that Asia was suffering from "massive structural problems."

"Japan is not suffering a cyclical downturn," he wrote, "it is caught in a structure that cannot respond either to fiscal or monetary stimulus."

In Washington, the head of the influential Institute for International Economics, C. Fred Bergsten, warned that "more global crises are coming", with Russia and Argentina as likely candidates, along with countries in Asia.

Morgan Stanley economist Stephen Roach warned that despite the US economy seeming to have reached a "sweet spot" of low inflation and solid growth, "something big is about to give."

However, even as they recognise that there is something very much amiss in the function of the world economy, none of these commentators pose, let alone address, the obvious question.

Why is it that in the midst of the greatest advances in technology and labour productivity in history together with the development of a truly integrated global financial system, world capitalism is being wracked by growing turmoil?

Such questions are not probed because even to pose them leads to other questions — such as whether this mounting turbulence is simply the result of wrong policies or mistakes, or is rooted in the fundamental contradictions of the profit system itself.