Conflicts in G7 as world economy moves closer to slump

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After months of discussion and warnings about the fragile state of the global financial system and calls for a new "architecture", the summit meeting of the Group of Seven finance ministers and central bankers held last weekend in Bonn was supposed to produce some concrete measures to at least alleviate, if not entirely prevent, a repetition of the crises that have erupted over the past year.

But rather than advancing policies to meet the global financial crisis, the summit meeting underscored the deepening divisions between the major capitalist powers.

The only measure agreed upon was a proposal by the president of the German Bundesbank, Hans Tietmeyer, to establish a "financial stability forum" involving the G7, the World Bank, the IMF, the OECD as well as national financial regulators, to discuss voluntary ways to co-ordinate and regulate the activities of hedge funds and banks and other financial institutions influencing global capital flows.

The most significant feature of the meeting was not the policies that were accepted but those that were rejected. At the insistence of the United States, the G7 ministers rejected calls by French President Jacques Chirac and German Finance Minister Oskar Lafontaine for the establishment of "target zones" for the world's three major currencies--the dollar, the euro and the yen--in order to stabilise exchange rates.

Speaking in Washington last week, Chirac said the G7 had to increase its capacity for "crisis prevention" and needed to adopt "a veritable traffic code or highway code for capital flows, a code which applies to all, including hedge funds and offshore establishments".

However, US Treasury Secretary Robert Rubin shot down the Chirac-Lafontaine proposal before the summit got underway. He said currency stability was economically useful but there were problems implementing it.

Rubin repeated the US call for increased economic growth in Europe and Japan, warning that the "international system" could not sustain large trade imbalances indefinitely. The latest figures show that the US trade deficit soared to a record $169 billion last year, with some $64 billion of the trade gap incurred with Japan.

Rubin's central objection to the currency plan was not just that Europe and Japan should be doing more to promote economic growth, thereby easing the pressure on the US economy, but that in the final analysis exchange rate regulation involved loss of US sovereignty.

"We think the way you achieve stability is through fundamental economic policy," he said. "When you start talking about measures such as bands ... you run into a whole host of other issues. If our currency is weak at a time when our economy is weak ... we could be required under that theory to raise interest rates at the very time when our economy is weak. That seems to us counter-productive."

This latter point is precisely the objection raised by the opponents of the US-IMF policy in East Asia, who point out that the high interest rate regimes imposed in South Korea, Thailand and Indonesia to maintain currency values have resulted in deep recession. It seems that what constitutes "sound economic management" depends on who is advancing it.

Reflecting the refusal of the US to entertain any sort of currency regime, the G7 communiqué spoke of the need to remain committed to domestically-based growth strategies to reduce external imbalances and promote growth in "emerging market economies".

Despite the obvious disagreements, it emphasised the need for "intensified cooperation" insisting that "sound economic fundamentals" were necessary for exchange rate stability.

While trying to cover over the differences between the major capitalist powers, the communiqué was forced to acknowledge the increasing tendency towards global slump. Financial conditions, it said, "have worsened in some regions and the outlook for global economic growth is less favourable. The impact of financial crises is now felt beyond the regions where the crises occurred."

Even as the summit was being held, new data on the German economy sounded a warning that it may be sliding into recession. Germany's gross domestic product for the December quarter last year declined by 0.4 percent, after growing by 0.9 percent in the previous three months. Significantly, the decline was concentrated in West Germany, where GDP fell by 0.5 percent.

Other figures showed that industrial production in France dropped 1.6 percent in December, while a major index of German business confidence hit its lowest point since August 1996.

Surveying the prospects for the world economy in its latest edition, the British magazine the *Economist* warned that it is "precariously balanced on the edge of a deflationary precipice" and that outside of America "the risk of falling consumer prices (i.e. deflation) is at its greatest since the 1930s".

The danger of deflation is that falling prices result in lower profits, bringing a decrease in investment and a consequent fall in demand, leading to further price falls. If the deflation continues for any length of time, it leads to higher real interest rates and growing indebtedness, as borrowers find that their incomes and assets decline in real terms while the amount they owe to banks and other financial institutions increases.

The *Economist* described the world economy as "precariously lopsided" because "even as America's economy continues to surge, much of the rest of the globe is drifting towards deflation. It is scary that America's boom, fuelled by an unsustainable stock market, is now the main prop for global demand."

Detailing the deflationary pressures, it noted that in the past two years its index of industrial-commodity prices had fallen by 30 percent and in real terms commodity prices were at their lowest levels since the index was first published 150 years ago. There is excess capacity in computer chips, steel, ships, textiles and chemicals while the car industry is estimated to have 30 percent overcapacity worldwide.

With the Japanese output gap--the difference between potential and actual output--expected to widen to 7 percent of gross domestic product this year, the country is on "the brink of a vicious deflationary spiral, with falling prices swelling companies' real debts and keeping real interest rates high".

"The rest of East Asia also has huge spare capacity. Even if growth resumes this year, Thailand's GDP is unlikely to regain its level of 1996 until 2001. If so, output will have fallen by almost one-third relative to productive potential (as measured by the economy's trend growth rate of 7 percent). Meanwhile, China has 40 percent excess capacity in manufacturing."

Overall, the *Economist* predicted that the output gap of the world economy would reach its widest margin since the 1930s by the end of this year.

"If the economies of America or Europe were now to take a sudden lurch downwards," it warned, "the world might easily experience outright depression, with prices and output falling together, just as they did 70 years ago."