The contradictions of surging US growth

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The release of figures by the US Commerce Department showing that economic growth reached an annual rate of 6.1 percent in the final quarter of 1998--up from the initial estimate of 5.6 percent--seems to signify that the American economy is continuing to shrug off the effects of global financial turmoil and is indeed powering ahead.

A closer examination, however, tells a different story. It shows that the surging US growth is only one aspect of a mounting imbalance in the world economy that could well be setting the scene for violent shifts in the future.

According to the Commerce Department, consumer spending rose at an annual rate of 4.8 percent--the highest for 14 years--enabling the US economy to record its longest expansion in peacetime history. Inflation meanwhile was at a low of 0.7 percent, and investment was rising.

But the results need to be set against the situation in the world economy as a whole. The news from Japan is of continuing recession, with a downturn in all areas. Consumer prices fell by 0.5 percent last year, retail sales dropped 5.6 percent and industrial production was down by 7.5 percent. Housing starts dropped by 11.2 percent in December on a year-on-year basis, marking the 25th monthly decline in a row, and reaching the lowest level in 14 years.

Economic growth in Europe, which was expected to pick up in 1999, now appears to be in decline. Preliminary estimates show that the German economy, the largest in the euro zone, declined at an annual rate of 1.8 percent in the December quarter, with indications that total GDP in the region may be stagnating.

The emergence of an increasingly lopsided world economy has prompted calls from US Treasury officials that Europe and Japan must do more to boost their domestic economies, cut back on their trade surpluses, and begin to absorb some of the exports from East Asia which have sent the US trade deficit to a record $169 billion. But such calls seem to be falling on deaf ears.

The communiqué from last month's meeting of G7 finance ministers contained no proposals for concrete action, merely noting that the participants "remain committed to a domestically based growth strategy that would contribute to achieving more balanced growth among our countries, reducing external imbalances and supporting recovery in emerging market economies".

The right words were put in place but as a comment in the *Financial Times* noted, they were largely "empty" as "in practice, Japan may be unable and the European Central Bank unwilling to achieve this".

The European Central Bank, which operates independently from the European governments, has made it clear it does not intend to pursue an easier monetary policy to lower interest rates and stimulate economic growth. Instead, it is demanding "structural reforms"--a code for the introduction of greater "deregulation" of labour markets.

In the wake of the failure of the G7 to reach any agreement on stimulating the world economy, US Treasury deputy secretary Larry Summers last week issued a warning to the Japanese government that the economy was continuing to deteriorate and that action had to be taken to stimulate demand to avoid deflation.

Speaking in Tokyo at the end of a tour of the Asian region, he said: "Prospects for Japan look worse than they did a few months ago, with forecasters now expecting another year of negative growth in 1999 and the IMF and private forecasts projecting a decline in prices.

"The global economy will not be able to fly permanently on a single engine. A global economy simply cannot be successful without a successful Japan."

He emphasised that the present policy of allowing the yen to fall in order to try to boost exports was not an alternative. "The exchange rate cannot be a substitute for policy," he said.

But Summers seems to have received short shrift from Japanese government officials and policy makers. In a remarkably blunt comment, Yukihiko Ikeda, described in press reports as the "policy chief" of the ruling Liberal Democratic Party, gave vent to some of the tensions now existing between the US and Japanese governments.

"Summers says 'Do this, and do that' but we will continue with steps already in the works," he said, adding that he had warned Summers that his remarks had more impact than he realised and urging him to think more carefully when he spoke.

With the failure of successive government spending packages to stimulate the economy, attention has turned to the question of monetary measures. But here there are deep divisions within financial authorities.

While the Bank of Japan has cut overnight call interest rates to 0.15 percent, and could send them even lower in the future, it has refused to either underwrite the issuing of bonds by the Japanese government or to expand its purchases of these bonds in the open market. This has given rise to the fear that as the government issues more bonds to finance its growing debts, the price will fall, leading to a rise in long-term interest rates [the price of a bond and the interest rate vary inversely] and further deflation of the economy.

On the other hand, it is argued, if the central bank does step up its bond purchases, thereby expanding the money supply, this could lead to a rapid fall in the value of the yen and the return of rapid inflation.

Other voices are demanding a "restructuring" of the Japanese economy in the face of a deepening crisis. In a comment published last week, the deputy business editor of the *Yomiuri Shimbun*, Mitsuo Miura warned that "excess" was now a major problem for the economy.

"On the microeconomic side," he wrote, "an excess of facilities and equipment is forcing profitability down in many industries. Overproduction is also leading to exacerbated competition. There is a real need to cutback on outdated facilities and equipment, and to make production more efficient.

"Twenty percent of electric furnaces in the steel industry, for example, have fallen into disuse, as have 30 percent of polystyrene production facilities in the synthetic fibres industry. Many other industries, including the semiconductor and automobile industries, are plagued with similar problems."

And in a blunt warning of the future facing Japanese workers, he added: "Another problem facing the economy is an excess of employees. It has been said that there are as many as 3 million employees on company payrolls who could be considered surplus to requirements. This surplus in the workforce is prompting many Japanese businesses to review their traditional life employment and seniority systems."

According to Miura, the "excesses" in the Japanese economy indicate that "the economic and social structures that supported postwar economic reconstruction, and the subsequent rapid economic growth, have now reached their limit. In this sense, eliminating excess means nothing less than reforming these structures. ...

"There are many macroeconomic excesses as well. The largest is the combined debt of the central and local governments. The public's 'excessive' demands for increased public services are contributing to the expansion of the role of government.

"The surging long-term interest rates, which stem from a growing concern over the massive issuance of government bonds, signifies how critical the current situation is."

The question of rising long-term interest rates, both in Japan and domestically, is of crucial concern for the US economy. Economic expansion has been financed in the main by the increase in debt of both consumers and corporations, stimulated by the so-called "wealth effect" of the stock market boom.

The rise of Wall Street, in turn, has been financed by the inflow of foreign capital used to purchase US bonds, thereby increasing their price and keeping interest rates down.

In other words, the global economy has only been prevented from sliding into recession by the inflow of funds into the US, which has boosted the stock market, thereby maintaining debt-financed spending at high levels.

But if interest rates begin to move upwards, either in the US or the rest of the world, this process could be rapidly thrown into reverse. This is why last week's fall in bond markets sent a tremor through Wall Street. The fear is that if long-term Japanese interest rates begin to rise, and bond prices in the US fall, investors will start repatriating their funds. A rapid decline in the bond market could spark a fall on Wall Street, leading to the reversal of the process that has ensured surging economic growth in the US, and tipping the world economy into a slump.