Falling euro a symptom of wider problems

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1 June 1999

The launch of the euro on January 4 was accompanied by the release of hundreds of balloons as finance ministers gathered in Brussels to proclaim a new era for Europe. Predictions were made that the euro could rapidly rise by as much as 40 percent on its opening exchange rate with the US dollar and soon become an international currency and store of value.

But five months on, the euro has plunged by nearly 12 percent from its opening rate of $1.18, with forecasts that it will soon hit parity with the US dollar.

The steady decline since the heady days of January accelerated last week with the announcement of an agreement by European Union finance ministers to allow Italy to ease its budget deficit goal for 1999 to 2.4 percent of gross domestic product from an initial target of 2 percent. Italian officials insisted that lower than expected economic growth meant they could not meet the original target.

Official predictions are for a 1.5 percent growth rate in the Italian economy. But most market estimates are for a rate of only 1 percent, raising the possibility that the deficit will blow out to as much as 2.7 per cent of GDP.

Even though these projections are still below the 3 percent level set under the terms of the single currency stability pact, the concessions given to the Italian government have prompted concerns in banking circles about the future direction of the euro.

While German chancellor Gerhard Shroeder sought to reassure markets with the assertion that the easing of Italian budget targets was a “one-off”, the president of the European Central Bank Wim Duisenberg had earlier issued a warning that the stability pact was “in the process of losing its forcefulness” and that further fiscal laxity could weaken the euro. The president of the German Bundesbank, Hans Tietmeyer, said he would “not be happy” if the euro fell further. His designated successor, Ernst Welteke declared that that drift towards parity with the dollar “had to stop".

If the Italian budgetary position had been the only concern, the decision to relax the deficit guidelines would probably have had a limited impact on the value of the euro. But the Italian deficit problems are only the symptom of a wider problem—stagnation in the European economy.

In an editorial on the euro last Saturday, the *Financial Times* pointed out that the “euro is weak mainly because the euro-zone economy is weak".

“The euro-zone economy has been worse affected by demand shocks from Asia and Russia than forecasters expected. Germany and Italy have been the worst victims. The OECD has cut its forecasts for these economies by more than 1 percent since last summer. Together they account for half of the euro-zone, and so they have dragged the European economy, and the currency, down.”

The editorial pointed to the problems this would create in the event of a fall in US growth rates.

“The major cause for concern,” it declared, “should not be the weakness of the euro but rather the weakness of the European economy. If strong US growth falters, the euro-zone is in no position to take over as the engine of world growth. The outlook for the euro-zone, if business confidence surveys ... are to be believed, is worse than the grimmest growth forecasts suggest.”

The editorial concluded with a call for a more vigorous implementation of the “free market” agenda demanded by the banks and financial institutions—cuts in social security and increased labour market “flexibility”.

The European economies, it insisted, “need to sort out their unwieldy social security systems, liberalise their labour markets, and foster greater competition in their product markets. Such reforms were neglected in the run-up to the euro's launch. Now the euro is up and running successfully—although at a weaker rate than most expected—governments have no excuse. They must begin the difficult but unavoidable reforms needed to make the euro-zone a success.”

The stagnation in Europe is only one expression of the problems besetting the global capitalist economy. Another area of continuing concern is the failure of the Japanese economy to exhibit any signs of recovery, despite the largest government expenditure program ever undertaken in the post-war period.

A recent article by Massachusetts Institute of Technology economist Rudi Dornbusch warned that the escalation of debt in Japan could become the “biggest financial crisis of the postwar period because the problem is out of control and the management is both distracted by politics and deeply confused as to the depth of the deterioration already in place.”

Dornbusch pointed out that while this may not be an issue this year or even the next, “when it comes it will be formidable.” “In a narrow way it is the Japanese recession—Japan is setting personal records for staying under water—which pulls down world growth directly but also adds to poor performance by limiting the recoveries of its Asian trading partners.”

Contained within the recession, he went on to warn, was an even bigger problem—Japan's huge public debt and unfunded pension liabilities. Market recognition that the debt problem is “out of control” had the potential for a “spectacular credit crisis.”

According to IMF estimates, Japan's public debt is now 130 percent of GDP. The OECD calculates that the net present value of pension liabilities is more than 107 percent of GDP—making the public debt liability the largest in the world.

A possible scenario for the “fatal debt dynamics”, Dornbusch warned, was a “financial meltdown of Japan, driven by deteriorating credit ratings, increasing Japan risk spreads, worsening balance sheets and debt dynamics, loss of confidence and deepening recession. Once the ball gets rolling, as with any distressed company or country, it goes all the way. And there is no IMF or US for the bail out because the numbers are staggeringly large.”

With economic activity in both Europe and Japan at or near recession levels, the world economy has only been sustained by growth in the US. But here too there are warnings of a rapid deterioration. The latest report by the Levy Institute Forecasting Center points out that the potential exists for a “dramatic deterioration in domestic and global business conditions".

The report warns that global overcapacity and global debt excesses contribute to the danger of the worst global financial crisis of the postwar era and that “with the [US] economy riding on a huge but vulnerable stockmarket bubble, there is a thin line between continued prosperity and disaster.”

“Although the world has moved away from crisis,” the report states, “the system's underlying vulnerability remains as great as ever. Any increase in stress on the system could quickly rekindle the global crisis, and this time we may not be so fortunate.”

The Levy Institute points out that the growth in US demand, which plays the central role in maintaining world growth, has only been sustained by a run down in personal savings as a result of the “wealth effect” generated by the stockmarket boom.

But this growth in US domestic demand, which has accounted for about one third of the world total since 1996, has resulted in an ever-widening balance of trade deficit. Already this year the trade deficit records for the first three months have been broken.

In a major speech delivered on May 6, Federal Reserve chairman Alan Greenspan pointed out that there was little doubt that the “marked widening in our trade deficit on goods and services have played an important, possibly a critical role in supporting world stability during these trying years.”

But as Greenspan noted, “there is a limit to how long and how far deficits can be sustained” because these deficits add to the US debt.

“It is very difficult to judge at what point debt service costs become unduly burdensome and can no longer be sustained. There is no evidence at this point that markets are disinclined to readily finance our foreign net imbalance. But the arithmetic of foreign debt accumulation and compounding interest costs does indicate somewhere in the future that, unless reversed, our growing international imbalances are apt to create significant problems for our economy.”

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