

# Danger of global crisis sparked G7 euro intervention

**Nick Beams****26 September 2000**

Fears that the continuing decline of the euro could set off a global financial crisis appear to have been behind the surprise decision of the financial authorities of the Group of Seven (G7) nations to intervene in currency markets last Friday.

The coordinated action, which involved the central banks of Britain, the US and Canada as well as the European Central Bank, is estimated to have mobilised about \$7 billion, lifting the euro from 85 cents to the US dollar to around 90 cents, before falling back to 88 cents.

In a statement issued in Prague, where they are gathered for the annual meeting of the International Monetary Fund and the World Bank, the G7 finance ministers and central bankers said the action had been taken because of "shared concerns ... about the potential implications of recent movements in the euro for the world economy."

The president of the European Central Bank Wim Duisenberg indicated the euro's weakness had reached a crucial point and that its misalignment against the dollar and the yen had gone far enough. "We wanted to stop that and introduce an orderly reversal," he said.

Bank of Canada governor Gordon Thiessen said there was a "shared concern that if the euro continued to fall the way it did, it had really serious implications." The G7 would continue to monitor the situation "and we are not ruling out further action if it seems to be required."

Officials of the ECB and finance ministers of the euro zone are believed to have taken the decision for intervention in the currency markets two weeks ago. But its implementation depended on support from the United States. After issuing comments opposing intervention, US Treasury Secretary Lawrence Summers is reported to have backed the move in discussions last Thursday.

However he insisted that support for the intervention did not mean any reversal of US policy. "As I have said many times, a strong dollar is in the national interest of the United States," he said. Asked how he could reconcile this statement with the decision to sell dollars and buy euros, Summers said: "I don't think there is any contradiction, but I don't want to go beyond the statement I made."

One of the factors that appear to have tipped the balance in favour of Washington's decision to support the euro is the effect of the falling currency on the profits of American companies operating in Europe and the impact this was starting to have on the volatile US stock market.

According to Bill Dudley, the chief US economist for Goldman Sachs: "The euro weakness was starting to affect US financial markets through the impact on US companies' earnings."

Last week major US firms, including Gillette, DuPont, McDonald's and Colgate Palmolive, which have considerable operations in Europe, indicated that their profit figures, when converted back into US dollars, were being hit by the sliding euro. When Gillette reported that the dollar value of its sales would fall by six percent in the third quarter as a result of the fall in several currencies against the US dollar, the news sent its stock falling by 7.3 percent.

In the statement announcing the intervention, G7 officials said they would "continue to monitor developments closely and to co-operate in exchange markets as appropriate."

The intervention does not mean that the risk of a financial crisis has lessened, and it may have even increased. As the London-based *Financial Times* noted in an editorial comment: "The G7 has taken a big risk, in two different directions. The first is that it is not

prepared to do enough. The currency is being driven down more by long-run investment outflows than by speculation. If these outflows are sustained, the euro needs to run a current account surplus to finance them. The weakness of the euro [which helps boost exports and the current account surplus] is then merely the mechanism through which this surplus is being achieved. If this outflow persists, spasmodic intervention will fail to halt the decline.

“The second risk is that intervention will succeed too well. In the past, central bank intervention has often succeeded in marking the turn in a currency. The dollar's rise could now reverse. Given the scale of the current account deficit, it could turn into a cumulative and destabilising fall. This concern is, no doubt, why US treasury secretary, Lawrence Summers, insisted upon the continued US desire for a strong dollar. It is easy to see why the authorities intervened. But having started, they must now succeed in stabilising the euro without destabilising the dollar. This is not assured. The G7 has merely made the first move in a long and complex game.”

Fears of where the move to push up the euro could lead were also voiced in an article published in Britain's *Sunday Times*:

“A concerted G7 effort to push the euro up would imply, by its nature, driving the US dollar down. If this provided the trigger for investors to reassess their holdings of US securities and pay greater attention to the imbalances in its economy, notably the current account deficit, it could send share markets crashing and bring about the very result finance ministers and central bankers do not want to see—a global recession brought on by a worldwide stock market crash.”

One of the main problems confronting the central bankers in organising the intervention is that the currency movements have been sparked by capital flows, rather than by the imbalances on the trade account. While the US is running a balance of payments deficit of over \$400 billion a year, equivalent to more than four percent of Gross Domestic Product, the dollar has been rising against the euro, despite the fact the countries of the euro zone have been running a trade surplus.

But the trade surplus has been outweighed by what the US magazine *Business Week* described as a “vast tidal wave of investment leaving Europe” attracted by

higher rates of return across the Atlantic. It estimated that investors and companies are shifting their money from Europe to the US at the rate of about \$3 billion per week and that in the first half of this year alone European companies made \$170 billion worth of acquisitions in the US.

This investment outflow and the consequent currency instability are placing added pressure on European governments to create a more favourable climate for business investment by further cutting back on social welfare measures.

As *Business Week* put it: “In the medium-term, Europe's politicians must make it crystal clear that they are serious about giving their shared economy a push by forcing through a packet of structural reforms that will make Europe as productive and flexible as the US. Taxes must come down further, labour markets must be deregulated and the process for setting up new businesses must be made easier.”

This was also the theme of an editorial in the *Australian Financial Review* on the decline of the Australian dollar and the message being delivered to the Australian government by international financial markets.

There were two lessons to be drawn from the crisis: the Australian government had to increase “fiscal discipline” and make the economy still more “efficient” and “competitive.”

“More competition and deregulation, further privatisation and labour market liberalisations and a smaller public sector are all imperative,” it declared.



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