US-European economic tensions increase

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With economic indicators still pointing to a downturn in the American economy, tensions between US financial authorities and the European Central Bank (ECB) have sharpened in the run-up to next weekend's meeting in Washington of the Group of Seven finance ministers.

Following the surprise decision by the US Federal Reserve Board last week to cut interest rates by a further 0.5 percentage points, the ECB appears to have dug its heels in over its decision to maintain European rates at their present level, making it the only major central bank not moving to bring rates down.

The ECB intransigence has brought some pointed comments from US treasury secretary Paul O'Neill. In an address to the New York Economic Club last Thursday, emphasising the importance to the world economy of growth in Europe and Japan, O'Neill said he was mystified by the apparent belief in some European capitals that their growth prospects were unaffected by developments in the US.

“When some Europeans say to me we're really excited about this year, were going to grow at 3.4 percent and we're going to show you how to do it (independently) I'm just mystified by that because it's so inconsistent with the world as I know it, because I think we're all in this together.”

His comments brought an immediate reaction in Europe where Swedish Finance Minister Bosse Ringholm, the current holder of the rotating presidency of the European Union, declared that the significance of the US was less than it thought.

“It is a fact,” he told a news conference, “that the American economy will mean less and less to Europe because the EU is becoming stronger and therefore European dependence will diminish. And that is a fact that the US will discover.”

The gulf between US and European financial authorities then appeared to widen further at a meeting last weekend of EU finance ministers and the ECB.

Commenting on O'Neill's remarks, ECB president Wim Duisenberg said: “It seems to me there may be some misconceptions on the American side. We are confident that we are weathering the storm to an extent that gives Europe a growth rate this year and next year at, or slightly above, the potential rate of the growth [2.5 percent]. We are not immune from developments in the US and world at large. But we are such a large autonomous area, with 300 million people, that the impact of developments outside the area is not negligible but very limited indeed.”

The ECB president's comments have been backed by European Economic Affairs Commissioner Pedro Solbes, who told the annual meeting for the European Central Bank for Reconstruction and Development that European growth was “expected to remain robust above trend potential in 2001 and 2002.” Solbes said European policymakers were better informed than O'Neill on the euro-zone economy.

While ECB representatives continue to insist that growth will be sustained, there is a growing realisation that the downturn in the United States is unlike any other which has developed in the post-war period. When it announced its interest rate cut last week the Fed made clear it was not simply the result of an inventory correction that would quickly come to a close, but pointed to more fundamental tendencies.

“Capital investment has continued to soften,” it noted, “and the persistent erosion in current and expected profitability, in combination with rising uncertainty about the business outlook, seems poised to dampen capital spending going forward.”

In response to the economic deterioration in the US, the International Monetary Fund has been revising down its estimates for growth almost on a weekly basis. According to a leaked report, the latest estimate is that the US economy will grow by only 1.5 percent this year, compared to the prediction last September of 3.2 percent, while world economic growth as a whole will be 3.2 percent, compared to an earlier prediction of 4.2 percent.

But these forecasts could well be moved downwards again. No one is sure how deep the slide in the US economy will be, what impact, if any, interest rate cuts will have, and what the effect will be on the global economy.

As the *Financial Times* commented in an editorial last Friday, the hope is that prompt action by Fed chairman Alan Greenspan will mean that rather than a long drawn out recession, the US experience will experience a short, sharp decline followed by strong growth. But, the editorial continued, to judge such a scenario it is necessary to know what kind of slowdown the US is experiencing.

"It is certainly different from anything experienced in the recent past. Unlike the 1970s, there is little inflation and therefore no monetary policy squeeze; on the contrary, monetary policy in the past few years has been as accommodating as it could have been. Instead, this slowdown has been triggered by a turn in the investment cycle."

The editorial pointed out that the US boom, which saw the share of investment rise from less than 10 percent of gross domestic product in the early 1990s to nearly 14 percent last year, was fueled by easy monetary policy and the expectation that real output growth would continue in the region of 4 or 5 percent well into the future.

"That was unsustainable. In the euphoric atmosphere, projects were funded that had little chance of being profitable, particularly in the technology sector. The country's capital stock ballooned to reach a level that the economy could not support. The result was the retrenchment that is now taking place. The cycle has more in common with the 1997 Asian crisis, which was also a result of overinvestment funded by cheap capital, than it does with past US downturns."

The comparison with the Asian financial crisis is significant. The "conventional wisdom" at the time was that the turmoil was a product of faulty banking practices and defects in the so-called "Asian economic model" which compared unfavourably with the "free market" agenda pursued in the US.

At least one economic commentator has cast doubt on whether the Fed's policy of cutting interest rates will bring about a reversal in the US slide.

According to Morgan Stanley Dean Witter chief economist Stephen Roach, while "aggressive monetary easing is the world's most powerful reflationary antidote" and the Fed has made clear its intentions with a 2 percentage point cut in just three and a half months, the biggest question of all remains whether it will work.

"Most of the time, the answer would be an unequivocal 'yes'. ... Yet there are those rare instances in history when economies have become surprisingly insensitive to monetary easing. America in the 1930s and Japan in the 1990s are the two classic examples. In those periods, both economies became mired in what economists call 'liquidity traps'—when the interest rate response was effectively neutralised by post-bubble balance-sheet constraints. When diagnosing a world in depression some 65 years ago, Lord Keynes equated the impotence of monetary reflation to 'pushing on a string.' Fast-forward to the 1990s and that's exactly the way it has played out in Japan over the past decade. Does the Fed face the same dilemma today? That's the clear risk, in my view."

Roach noted that while there were differences between the US and Japan, the American economy was coming off the "greatest stock market bubble in the post-Depression history of the United States," leaving "good reason" to doubt its ability to respond to the Fed's method of treatment.

Whatever the precise course of the US and world economy, the economic history of the recent period demonstrates that divergences between the major capitalist powers can, at some point, can have a major impact.

One only need recall the situation at the end of the 1970s. Then, the refusal of the European powers, in particular Germany, to adopt the Carter "reflation" strategy and act as a "locomotive" for the world economy, led to a collapse in the value of the dollar and the installation of Paul Volcker as head of the US Federal Reserve on a program of lifting interest rates. The outcome was the most severe recession since the 1930s.

A decade later, conflicts between the US treasury and the German Bundesbank saw a withdrawal of capital from US markets, precipitating the stock market collapse of October 1987.

Under conditions of a slide in the US, with its consequent flow-on effects to the rest of the world, the economic policy differences between US financial authorities and the ECB could have no less far-reaching consequences than those of the past 20 years if they continue to widen.