US downturn deepens trend to world recession

Nick Beams
31 July 2001

National accounts data from the US, published last week, reveal that far from experiencing a "V-shaped" recovery, the slide in the US economy is getting steeper. Preliminary figures showed that the economy grew by an annual rate of only 0.7 percent in the second quarter, down from the rate of 1.3 percent for the first three months. Had it not been for increased spending by local authorities, the economy would have contracted.

The most significant feature of the figures was the drop in capital spending which fell at an annual rate of 13.6 percent. This was the steepest decline since the recession of 1982. However, unlike the situation at that time, the downturn has not been induced by high interest rates. On the contrary, interest rates have been cut. The downturn is the outcome of falling profits and the growth of overcapacity in all sections of the economy, particularly communications and high-tech industries. Just 18 months ago, when the "new economy" was the latest phrase, the US economy was growing at one point at the rate of 8.3 percent. While it is not yet officially in recession, the turnaround is one of the most rapid in the postwar period.

Another striking feature of the deepening slump is the rapidity with which its effects are being transmitted internationally via the cutbacks in US imports.

The importance of the US market for the global economy is reflected in the fact that it accounts for about one quarter of the exports of the rest of the world. The growth rate in US imports has fallen from 17 percent nine months ago to minus 5 percent today. The crucial component in this 22 percent turnaround is the fall in imports of capital goods, especially in the high-tech area. Since their peak last September, they have fallen by 20 percent, making up some 80 percent of the overall decline, and sending a shockwave around the world.

In Japan, the government announced on Monday that industrial production had fallen by 0.7 percent in June—well above the 0.4 percent decrease predicted by most economists. The main reason for the decline was falling international demand for semiconductors and other information technology productions. Production for the April-June quarter fell by 4 percent, following a 3.7 percent decline in the January-March period.

The industrial production figures make it almost certain that the Japanese economy as a whole will have experienced negative growth in the second quarter, following a 0.2 percent contraction in the first quarter, meeting the definition of a recession defined as two quarters of negative growth.

If the impact of the American downturn is proving to be severe for Japan, it is having potentially devastating effects in East Asia. Following the financial crisis of 1997-98 the economies of this region became even more dependent on the US market as the high-tech boom boosted demand for exports.

A comment published in *BusinessWeek* of July 30 claimed that while Asia would not go through a repeat of 1997 it nevertheless faced a crisis of a different "and more chilling nature." With the collapse of the US boom, "Asia doesn't have a leg to stand on" with domestic consumption down and banks still wallowing in bad loans.

The comment noted that trade figures were looking "increasingly ugly." For the first five months of the year global trade grew by only 4.3 percent compared with 12.8 percent last year. In South Korea, where information technology accounts 12 percent of gross domestic product, chip exports have dropped by 25 percent this year. If the export decline continues for more than a few months, many firms will face major financial problems.

According to *BusinessWeek*, the chipmaking firm Hynix Semiconductor Inc is "getting hammered" by the collapse in memory-chip prices and still has debt of $8.7 billion, prompting a warning from the firm's CEO that if the decline continues into next year "the whole industry will collapse." The debt problem is not confined to the high-tech sector. The Bank of Korea has reported that 38 percent of manufacturers did not make enough in the first quarter to cover their debts.

Recessionary trends are also becoming more evident in Europe. In Germany, the Ifo index, which measures business confidence, dropped again last month, from 90.8 to 89.5—a bigger-than-expected decline—while the growth rate for the economy is expected to be only 1 percent this year. In Britain the economy expanded by only 0.3 percent in the second quarter, the lowest increase since the end of 1998 when the effects of the "Asia crisis" were being transmitted around the world.

It is also becoming clear that the development of a global slump is organically connected to the events of three years ago. The "Asian crisis", far from being a one-off event or the result of regional "crony capitalism", was the expression of global tendencies now manifesting themselves in the form of a major downturn in the main "engine" of the global economy, the United States.

In February 1999, the British magazine *The Economist* estimated that the output gap—the difference between the potential and actual output on a global scale—had reached its biggest margin since the Great Depression of the 1930s.

That gap did not disappear over the next period. Its existence was only masked by the inflow of capital into the US and the consequent financial bubble and investment boom. With the collapse of the bubble from the middle of last year the underlying recessionary trend has returned.

It has brought with it renewed fears of a financial crisis, this time centring on the US dollar. Since it reached its lowest-ever point against the Japanese yen in the first months of 1995, the US dollar has risen by 25 percent against a broad basket of international currencies.

But this is causing troubles on two fronts. On the one hand, the dollar's high value is pricing US exports out of world markets, while on the other it is depressing the profit figures for major US multinational companies. Profits made abroad, in local currencies, are translating into lower figures in dollar terms. This situation has led to warnings by some US companies, including Heinz, Kimberley Clark, Pfizer and International Paper, that the strong dollar is cutting their profits.

While a weaker dollar would provide a boost to the US economy, financial officials are reluctant to call for it, lest they precipitate a sudden exit of capital from US markets. With the US economy needing an inflow of foreign capital of more than $1 billion a day to finance its balance of payments deficit, a sudden outflow could have serious consequences, including a rise in long-term interest rates and a further fall in the stock market.

The growing disequilibrium in the world financial system resulting from the over-valued dollar would be serious enough on its own. But it is compounded by the worsening situation in Japan.

According to the latest estimates from the investment banker Goldman Sachs, Japan's bad bank loans may total as much as $1.9 trillion, equivalent to half the country's GDP. While this estimate has been disputed, there is no denying the fact that the stagnation in the economy is creating new bad loans as fast as old debts are being written off.

But policies aimed at wiping out the bad loans will push the economy deeper into recession and could trigger a major decline unless accompanied stimulatory measures. The problem facing the Koizumi government is that it has few options on this score.

Government spending may be increased but with the government debt already running at 130 percent of GDP, the scope for fiscal action is limited. Moreover, the measures carried out so far—the largest ever implemented by any capitalist government—have failed to bring about economic expansion.

Neither will a stimulus come from reduced interest rates, which are already close to zero. This leaves monetary policy as the only option. The most widely advocated policy is that the Bank of Japan should pump more liquidity into the financial system, bringing a fall in the value of the yen and an increase in inflation.

But this scenario is complicated by the deepening slump in the US economy. A fall in the value of the US dollar would help stimulate the US economy and also boost the value of the euro, lessening inflationary pressures, and enabling the European Central Bank to cut interest rates.

But a falling US dollar directly conflicts with the Japanese government's need for a falling yen to try to prevent bank restructuring from turning into an uncontrollable slump. Such conflicts could well provide the material for major financial turmoil in the coming months, on top of the major problems already flowing from the accelerating US downturn.