Whistling in the dark at G7 finance meeting

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Children used to be told that if ever they were walking past a graveyard at night they should look straight ahead and whistle a tune in order not to become frightened. It seems that the leaders of the major industrial powers have adopted this policy in regard to the world economy, if the meeting of the Group of Seven (G7) finance ministers held in New York on Saturday is anything to go by.

Before the meeting got under way, European Central Bank council member and German Bundesbank president Ernst Welteke defied warnings of a severe downturn and a crisis of confidence. “I see no recession in the world, euro zone or Germany, either in a technical or general sense,” he told a press briefing.

While US Treasury Secretary Paul O’Neill was forced to acknowledge last Friday that the US economy would almost certainly suffer negative growth in the third quarter and a “delayed recovery” by a quarter or so, he joined his fellow finance ministers in maintaining an optimistic outlook. O’Neill told his Japanese counterpart, Masajuro Shiokawa, that the US economy would recover by the middle of next year.

Shiokawa too was anxious not to cast a pall over proceedings. However, because he could not find any good news from the Japanese economy—presently in the midst of its fourth recession of the past decade—he decided to offer up a familiar mantra. “It is worth stressing,” he told reporters, “that the fundamentals of the world economy are sound.”

In its communiqué, the G7 meeting studiously avoided the word “recession” and offered reassurances that governments would take whatever action was necessary to ensure that any downturn was a short one.

“Last month’s terrorist attacks could delay the resumption of strong growth in our economies,” the communiqué stated. “Decisive action has already been taken to support a robust recovery. Notwithstanding remaining short-term uncertainties, we are confident about our future prospects. We are strongly committed to bringing forward needed measures to increase economic growth and preserve the health of our financial markets. We will continue to monitor exchange markets closely and co-operate as appropriate.”

It is precisely in the area of co-operation that some of the main problems reside, however. In an attempt to hide their differences, the finance ministers even resorted to holding a joint press conference following their discussions—a departure from the past practice of holding separate ones. This action “again makes clear how close (is our) cooperation and way of thinking,” German Finance Minister Hans Eichel told a news conference.

Nevertheless, no concrete measures were proposed. O’Neill said the commitment to “bringing forward measures to increase economic growth” meant that the member nations had promised to promote growth, but each would do so in its own way.

The lack of agreement on specific policy measures was underscored in the lead-up to the meeting. Last Thursday, in a clear call for more concerted European action, O’Neill insisted that there had to be a “worldwide recovery”. “The US economy has been carrying most of the rest of the world, especially in the last year ... we need to all pull together,” he said.

The US administration, which has committed itself to an additional $130 billion in tax cuts and higher spending over the next year, wants the European powers to follow suit. But they are reluctant to undertake such measures, fearing they could undermine the 1997 fiscal stability pact, which is the basis for the common currency, the euro.

Last week Eichel dismissed the prospect of a joint stimulus package, saying, “generally, such programs do not bring much,” while German Chancellor Gerhard Schroeder has repeated his support for the maintenance of the stability pact. According to Eichel, increased spending would be self-defeating as it would force up long-term rates and prevent the European Central Bank (ECB) cutting short-term rates. “A softening of the stability pact would undeniably lead to monetary policy being unable to make its contribution to growth,” he said.

France’s finance minister Laurent Fabius shares these positions. Speaking before the G7 meeting, he said: “It wouldn’t be reasonable or efficient to change the stability pact ... it will have a negative effect on our economies, particularly long-term interest rates.” Fabius praised the actions of the ECB in cutting interest rates by half a percentage point after the September 11 terrorist attack and voiced the hope that there would be further cuts—a view he repeated immediately after the G7 meeting.

“The European Central Bank has already cut interest rates, but in my view there is no risk of inflation and there is still margin for maneuver,” he told reporters after a meeting with O’Neill.

Yet, there seems little prospect of a further ECB rate cut, following the 0.5 percentage point reduction in the wake of the September 11 events. ECB president Wim Duisenberg said on Sunday that the present rate was consistent with the bank’s goal of fighting inflation. Without further information, “this monetary policy is the right one”. Duisenberg discounted suggestions that a cut was necessary to combat recession, saying that the European economy would be in an upswing by the end of the year because of low inflation, a sound balance of payments situation, existing tax cuts and wage moderation.

Aside from the question of whether the governments and central banks of the major capitalist powers can reach agreement on concrete measures, there are more fundamental reasons why stimulatory measures—either in the form of interest rate cuts or government spending—will have little effect in reversing the global downturn.

The main one is that the slowdown has not been induced by previous interest rate hikes but arises from overcapacity in the main centres of the world economy. This has led in turn to falling profit rates and increased global competition as firms struggle for their market and profit share. The most obvious examples of this process are the high-tech telecommunications and airline industries, which have been experiencing major problems for more than a year. Overcapacity, however, is not confined to these industries but extends to car production, electronics, steel, chemicals and other key sectors.

Furthermore, the claim that stimulatory action can restore economic growth ignores recent economic history. The eruption of the Asian financial crisis four years ago was the initial expression of overcapacity and the recessionary tendency within the world economy.

The US Federal Reserve Board prevented outright global recession at that time by taking major stimulatory action. The interest rates cuts in 1998 and the increases in liquidity with the approach of the year 2000 fuelled a financial bubble and induced rapid growth rates in the US economy as a result of increased capital spending. The bubble-induced US growth led to a boom in world trade, helping to boost the Asian economies, and countering the effects of low growth in Japan and Europe. It has been estimated that the US economy alone accounted for about 40 percent of the growth of world gross domestic product at the end of the 1990s.

However, the US financial bubble could not overcome the fundamental problems that had surfaced in the Asian crisis and it was only a matter of time before it collapsed and the recessionary trend re-emerged. In other words, if monetary policy—nine interest rate cuts by the Fed since the start of the year—is having little effect in reviving economic growth, it is because it was the previous loosening of monetary policy to combat the threat of recession three years ago, which helped create the conditions for the present downturn.

Hence the turn to the use of fiscal measures—the attempt to revive economic growth by increased government spending. But here too recent economic history casts doubt on the possibility of success. Over the past decade, some 10 fiscal packages have been introduced to try to boost the Japanese economy following the collapse of its financial bubble in the early 1990s. Despite government spending equivalent to around 25 percent of GDP over this time, the Japanese economy, the world second largest, is again turning down, and may well be pointing the way for the rest of the world.