Economic problems mount as G-8 summit meets

Nick Beams
26 June 2002

When the United States recorded a 5.6 percent growth rate for the first quarter of this year it appeared, at least to short-sighted observers, that it would be plain sailing out of the recession that commenced in March last year. In fact, doubts were even expressed that the economy had undergone a recession at all. It is a vastly different picture a few months on.

This week's meeting of the Group of Eight—the seven major industrial nations, plus Russia—in the Canadian ski resort of Kananaskis will take place amid financial problems, which are threatening to become as serious as those that developed after the Russian default in 1998 and the collapse of the US hedge fund Long Term Capital Management (LTCM).

Following the bankruptcy of Argentina earlier this year, Brazil, South America's largest economy, is entering a major financial crisis, as economies the length of the continent are hit by growing turbulence—all of which has developed contrary to reassurances that the Argentine crisis would be contained.

Four years ago, a major intervention by the US Federal Reserve Board, including a $3 billion bailout of LTCM and the rapid loosening of credit, prevented a major crisis of the global financial system. But the conditions under which this intervention was carried out have changed dramatically.

Instead of riding high, as it was then, the US dollar is sliding, the stock market bubble has collapsed, the chances of a "double dip" US recession are increasing and profits are continuing to trend down.

Whether the G8 meeting will seriously discuss the mounting problems, however, is another question. Following their lead-up meeting in Halifax, Canada, which ended on June 15, G7 finance ministers declared they were "confident about future prospects" prompting the *Economist* to comment that the phrase would strike some as "either blind optimism or breathtaking complacency—or both."

In a comment published on June 21, Morgan Stanley chief economist Stephen Roach described the world economy as "tipping again."

"Geopolitical tensions," he wrote, "remain at boiling point, and recovery in the global economy looks shaky, at best. Meanwhile, financial markets are seizing up in the industrial world, and crisis is the only word to describe conditions in Brazil that are rapidly spreading to other Latin currencies. All this is starting to seem reminiscent of the dark days of late 1998 and early 1999. Yet there's one key difference: America is not in any position to save the day by administering the tonic of global healing that worked so well three years ago. That puts the global outlook in an exceedingly difficult light."

The most obvious expression of the worsening outlook is the decline in US equity markets, which have fallen to the lows they reached following September 11. The downturn is particularly significant because, according to the national accounts data, the US economy is beginning a recovery. As the *Economist* pointed out, this is the first time since the 1920s that the start of an upturn has been accompanied by a fall in the market.

It is not the only publication to point to events of that era. With one financial scandal after another engulfing some of the biggest names in the corporate world—from Enron, to Arthur Andersen, WorldCom, Tyco and Global Crossing, to name but a few— *Fortune* magazine drew some parallels with 1929 in its cover story this week.

"Phony earnings, inflated revenues, conflicted Wall Street analysts, directors asleep at the switch—this isn't just a few bad apples we're talking about here. This, my friends, is a systemic breakdown. Nearly every known check on corporate behaviour—moral, regulatory, you name it—fell by the wayside, replaced by the stupendous greed that marked the end of the bubble. And that has created a crisis of investor confidence the likes of which hasn't been seen—well since the Great Depression."

As if to confirm this pronouncement, the following day WorldCom, the second biggest long-distance telecommunications carrier in the US, announced that it had fired its chief financial officer after discovering that almost $4 billion of expenses had been improperly accounted for. The company, whose records had been examined by the Enron auditor, Arthur Andersen, said that transfers in internal accounts of $3.06 billion in 2001 and $797 million in the first quarter of 2002 had enabled the company to show a net profit instead of a loss.

Rather like Captain Louis Renault, the police inspector in the film *Casablanca* who "discovers" gambling going on in Rick's Café, WorldCom CEO John Sidgmore said the company's senior management team was "shocked" to find that accounting irregularities had taken place.

But judging by the overall situation, it would be been even more surprising if they had not. According to the *Economist*, almost 1,000 US companies have "restated" their earnings since 1997, "admitting in effect that they had previously published wrong or misleading numbers."

Lack of confidence by investors is not the only reason for the decline in stocks—objective economic relationships are playing a role.

Even though there has been a marked decline since March 2000, the price earnings ratio for the S&P 500 index is at 29, compared with the historical norm of 16. According to one London analyst, cited by the *Economist*, the American share market is overvalued by more than two fifths on the basis of the Tobin Q index which measures the ratio of share prices to the replacement cost of corporate assets. Even if profits were to grow by 7 percent per year (an optimistic assumption given that they increased only 1 percent in the first quarter of this year) stock prices would need to remain stationary for the next eight years to return ratios to their historical norms.

Moreover, the problems confronting the US and global economy are not confined to equity valuations. The collapse in share prices has only exposed the fundamental imbalances that have been steadily developing over the past decade.

Ever since the collapse of the so-called Asian economic miracle in 1997-98, the world economy has been dependent on expansion of the US economy to provide the impetus for growth—it accounted for about half the increase in world growth over the past five years. But high US demand has fuelled an ever-widening trade gap, requiring an inflow of more than $1 billion a day to finance it.

The latest current account data show that the situation is worsening. The payments gap for the first quarter of this year was $112.5 billion, equivalent to 4.3 percent of gross domestic product. The deficit will only start to decline if US demand falls. But if that happens the world economy will enter a recession.

On the other hand, if the deficit is not cut back it will require an ever-greater inflow of capital from the rest of the world to finance it. While the stock market was booming and the dollar was still high, financing the payments gap was not a problem. It is a different story now.

According to a report in the *Financial Times*, in the second half of 2001, net direct investment plus purchases of corporate stocks were *minus* $16 billion. Demand for bonds, it noted, remained strong but "the willingness of foreigners to buy bonds is vulnerable to currency risk."

In the words of one analyst cited by the *New York Times*: "We risk seeing a flood of dollar selling as everybody tries to get through the door at the same time."

According to Clyde Prestowitz, president of the Economic Strategy Institute, it had been known that the dollar was at the upper range of its value. "We've known for a long time that the trend of the current account deficit is unsustainable, and we've known that the longer it goes on the greater the chance that the adjustment could be disorderly."

What such a "disorderly adjustment" could mean was indicated in 1987, when a decline in the dollar helped precipitate a movement of money out of US markets, setting off the October stock market crash.