

Deflation threatens world economic growth

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The close of 2002 has seen the prospects for the long-term expansion of the global capitalist economy become increasingly problematic. Accounting for more than 70 percent of world production, the three main regions—the US, European Union and Japan—determine the future direction of the global economy. But it is here that the main problems reside.

The Japanese economy shows no sign of breaking out of the stagnation that has gripped it since the collapse of the share market bubble at the beginning of the 1990s. The eurozone is faring little better and is being dragged back by near-recession conditions in its largest economy, Germany, while the US economy is experiencing a series of fits and starts. After growing at an annual rate of 4 percent in the July-September quarter, the economy is expected to expand by only 1.4 percent for the last three months of the year.

Overall, the Organisation for Economic Co-operation and Development expects that the world economy will grow by only 2.2 percent next year after growth of 1.5 percent this year. A world growth rate of less than 2.5 percent is regarded by many economists as marking the onset of a recession.

A breakdown of the figures reveals some of the growing structural imbalances within the world economy. The OECD estimates that while the US accounts for 31 percent of world production, it will generate 52 percent of the increase in world demand for 2002. Total domestic demand is estimated to have grown 2.8 percent in the US, 0.7 percent in the EU and *minus* 1.4 percent in Japan.

In other words, with capital spending in Europe showing no signs of an increase after falling for the past seven quarters and Japanese consumption and investment spending continuing to stagnate, the limited growth in the world economy is becoming ever-more dependent on the expansion of the US economy.

But with little or no growth in the rest of the world,

the only way the US economy can continue to expand, even at the lower growth rates of the past two years, is by a further increase in debt, both externally and internally.

Already US spending is 5 percent greater than its income—the difference being reflected in the balance of payments deficit. At present this deficit requires an inflow of \$1.4 billion per day from the rest of the world to finance it, but this could rise to \$2 billion if present trends continue. And if the payments deficit continues at its present rate of around 5 percent of gross domestic product (GDP), the net external liabilities of the US, at present over 20 percent of GDP, will climb to 50 percent within five years.

What this means is that in the absence of any prospects for economic expansion in Europe and Japan, growth in the world economy is dependent on processes in the US that are unsustainable in the long term.

Precisely how these processes unravel remains to be seen. But already the depressed state of the world economy as a whole and the lack of any sustained recovery in the US are prompting fears that Japan's decade of stagnation may not be an exception but could turn out to be the rule.

After the November decision of the US Federal Reserve Board to cut interest rates by a further 0.5 percentage points, these concerns were reflected in the speech delivered by Fed chairman Alan Greenspan to the Economic Club in New York on December 19.

Greenspan began by pointing out that the central issue in most major economies in the post-war period was the emergence of and then battle against inflation while “concerns about *deflation*, one of the banes of an earlier century, seldom surfaced.” However this has now changed.

“The recent experience of Japan,” Greenspan continued, “has certainly refocused attention on the

possibility that an unanticipated fall in the general price level would convert the otherwise relatively manageable level of nominal debt held by households and businesses into a corrosive rising level of real debt and real debt service costs.”

Greenspan pointed out that recent experience had “stimulated policymakers worldwide to refocus on deflation and its consequences, decades after dismissing it as a possibility so remote that it no longer warranted serious attention.”

While hastening to offer the reassurance that the US is “nowhere close to sliding into a pernicious deflation,” he did acknowledge that even though the US economy had largely escaped any deflation since World War II, “there are some well-founded reasons to presume that deflation is more of a threat to economic growth than is inflation.”

It is a measure of the turn in the economic situation that deflation, which only a relatively short time ago was regarded as a result of some of the peculiarities of the Japanese economy, should now be regarded as a threat to the US. That the once unthinkable has become a reality is a result of the events of the past two and a half years—the collapse of the share market bubble; the revelations of widespread false accounting, not to speak of outright looting; the contraction in investment and the emergence of over-capacity in all sections of the US and world economy; and the failure of record interest rate cuts to have any significant impact on economic growth—to name a few.

Greenspan did not hold out any great hope for an upturn in US economic prospects in the immediate future. While new orders for capital goods—a central component any sustained expansion—had stabilised, this did not signify the beginning of a vigorous recovery.

“In the end, capital investment will be most dependent on the outlook for profits and the resolution of the uncertainties surrounding the business outlook and the geopolitical situation. These considerations at present impose a rather formidable barrier to new investment. Profit margins have been running a little higher this year than last, aided importantly by strong growth in labour productivity. But lack of pricing power remains evident for most corporations. A more vigorous and broad-based pickup in capital spending will almost surely require further gains in corporate profits and cash flows.”

There is little evidence that either of these events will take place. Moreover, the Federal Reserve Board is running out of room to manoeuvre. Having already cut interest rates to just 1.25 percent, it could soon be facing some of the same problems that have confronted the Bank of Japan where close-to-zero interest rates have left it with few policy options to combat deflation.



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