

World economy sliding towards deflation and recession

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While it provided a short-term boost to share markets, last week's decision by the European Central Bank (ECB) to cut interest rates by 0.5 percentage points is another indication of the worsening outlook for the global economy.

Immediately prior to the cut, the European Union statistics agency, Eurostat, announced that economic growth for the euro-zone had come to a halt in the first quarter following growth of only 0.1 percent for the last three months of 2002. The main reason for the stagnation was a big fall in investment together with declining export revenue, due to the rise of the euro against the dollar. Only increased consumption spending prevented the euro-zone recording negative growth. Three of the region's economies—Germany, the Netherlands and Italy—were already in or close to recession.

There is no sign of a significant upturn in the future. According to EU forecasts, citing weak “domestic and foreign demand”, there will be no growth in the second quarter and only a 0.4 percent increase in the third.

The European figures assume added significance for the world economy when taken together with the latest results from the US and Japan where all the signs point to deflation and, at best, very low growth rates.

While the annualised US growth rate for the first quarter came in at 1.9 percent, the period from January to April saw the slashing of 500,000 jobs. In May, the unemployment rate climbed to 6.1 percent—its highest level in nine years—after the axeing of a further 17,000 jobs.

The worsening jobs figures have been accompanied by a report showing that US factory orders declined 2.9 percent in April, the biggest drop in 17 months. Machine orders fell 4.7 percent, transport equipment 5.1 percent and electrical products 1.9 percent.

And the US economy is not likely to turn around in the immediate future according to one of the most recent

forecasts. A survey by the Anderson School at UCLA predicted at least a year of weak growth with little increase in employment. On top of the decline in business activity, the economy was being hit by the severe budget problems confronting state and local governments.

According to Ed Learner, the economist who wrote the report, the US economy is “stuck in the mud” with the year ahead looking “very weak”. He predicted growth of only 2.2 percent for 2003, well below the rate of 4 percent to 5 percent needed to increase employment.

With a fall off in business investment, the US economy has been kept afloat by increased consumption spending, made possible by low interest rates. But this may have come to an end if a report in Monday's *Financial Times* is anything to go by.

“Across the US,” it noted, “stocks of unsold cars, pick-up trucks, sports utility vehicles and minivans (people carriers) are building up at the dealerships. Ford and General Motors together have 400,000 or so excess vehicles—equivalent to the yearly output of two medium-sized factories.”

Chrysler has warned of a \$1.2 billion loss in the second quarter and expects to barely break even for the year, after previously forecasting an operating profit of \$2 billion.

According to the *Financial Times*: “Most analysts agree that Chrysler's profit warning will soon be followed by similar announcements from GM and Ford.... Some are even beginning to talk about the possibility of a bankruptcy, with one of the Big Three going into Chapter 11 [bankruptcy] in order to offload pensions liabilities.”

The article pointed out that because of the decline in the stock market and low inflation the Big Three have a “black hole” in their pension funds and owe “tens of billions of dollars” of unfunded health care promises to retired employees.

Throughout the 1990s, the deflationary decline of the Japanese economy was regarded as an aberration. Now it

is beginning to look like the rule, as the same tendencies emerge in Europe and the United States.

In Japan the obligatory calls for radical policy measures to arrest the decline are still being issued at regular intervals. But no one has any confidence that the situation can be turned around.

The latest such exhortation came from International Monetary Fund deputy managing director Anne Krueger during a visit to Tokyo last week.

“A bold and comprehensive policy package is needed to enable the economy to escape from its present deflationary trap,” she declared.

But just what that policy might be was by no means clear. Krueger said Japan should set a medium-term inflation target, which would “help convince the public that deflation will end, and encourage spending.”

In essence such a program involves the central bank injecting more money into the economy. But previous massive injections have had little effect. Over the period 1997 to 2002, the Japanese monetary base expanded by some 84 percent but the overall economy showed a 6 percent decline in nominal gross domestic product.

Other options are increasingly being closed off. With the US dollar now falling, Krueger warned that Japanese authorities should not try to push down the value of the yen in order to boost the economy through an increase in exports.

Nor is government spending an option. Now equivalent to around 150 percent of gross domestic product, the “public debt is high enough to be a source of concern if it continues growing at the current rate,” Krueger warned.

“It is our view that there is not very much, if any, room for expanded government expenditure, or so-called fiscal stimulus. That indeed has been tried for several years and has had perceptibly little effect,” she said.

The interest rate cut by the ECB, coupled with the continuing emergency measures in Japan, and the expectation that the US Federal Reserve Board will soon cut interest rates again means that financial authorities in the world’s three largest economies—comprising some 50 percent of global output—are pursuing anti-deflationary measures.

But, as the Japanese experience over the past decade demonstrates, they do not enjoy strong prospects of success. This is because the present recession-deflation does not have the same characteristics as other downturns in the post-war period. Unlike previous recessions, it has not been set off by the tightening of monetary or fiscal policy, but is the result of the collapse of a series of

financial bubbles—starting in Japan at the end of the 1980s and moving through to the US at the end of the 1990s—which have left a mountain of debt and excess industrial capacity in their wake.

In such a deflationary environment, the greatest danger is that the decline in the value of the asset backing for loans sets up a crisis in the financial system. So far these effects have only been seen in Japan. But this could rapidly change.

As Morgan Stanley chief economist Stephen Roach warned in a comment published on June 2: “The risks of a deepening deflationary shock in Germany cannot be minimised, especially in light of the fragile state of its financial system—banks and life insurance companies, alike. Due to Germany’s sheer size, as well as its linkages to the rest of Europe, a deflationary shock in Germany could easily unleash a pan-regional contagion that could wreak havoc of the rest of the EMU.”

In the United States, the recent upturn in the market masks a worsening situation in the economy as a whole. The continued decline in manufacturing—highlighted by the approaching crisis in the car industry—points to the fact that the Fed’s ability to prevent a full-scale recession may be coming to an end. In any case, interest rate reductions were never conceived of as a long-term solution. They were regarded as a measure to buy time until business investment—the driving force of the capitalist economy—increased. But there is no sign of that taking place under conditions of contracting world growth amid continued excess capacity.



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