G7 meetings highlight deepening problems for US and world economy

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Last Friday's plunge on Wall Street, which saw the Dow Jones fall by more than 360 points, or 2.6 percent, was a stark warning that, far from having passed, the problems created by the subprime crisis and credit crunch may be only just beginning. On Monday, the market went up, but only by 45 points in what the *Wall Street Journal* described as a "moody day".

One reason for the sell-off was the growing signs that US growth is set to decrease and that the economy may even slide into a recession. The giant machinery manufacturer, Caterpillar, has already stated that, so far as it is concerned, the US economy may already be in a recession, or very close to one.

All the major economic news reinforces concerns that the US economy is heading for a downturn. The price of oil has gone over $90 per barrel in recent days with predictions that $100 may not be far away.

At the same time, the American economy is being hit by the on-going housing slump, which is set to worsen in coming months as more people default on their mortgages leading to increased forced sales and lower prices.

A report published by Bloomberg cited the assessment of veteran Wall Street analyst Ivy Zelman, who warned that it was unlikely the US housing market would recover before 2009.

Zelman said there was a 50 to 60 percent chance of a recession and that she had "never seen the market as bad as this." Zelman, who had been warning of a crisis for some time because of the tendency of house prices to far outstrip increases in personal income, said the situation could get much worse with house prices dropping by between 16 and 22 percent.

In this context, the meeting of the Group of Seven (G7) finance ministers and central bankers held in Washington over the weekend—the first since the financial crisis erupted in August—put forward no measures to deal with the mounting global economic and financial problems and only served to demonstrate the deepening divisions among the major powers.

France and Germany wanted the final communiqué to refer to the problems confronting Europe because of the falling US dollar, but the proposal was vetoed by US Treasury Secretary Henry Paulson. Instead, the meeting confined itself to issuing a warning to China to allow its currency, the renminbi, to appreciate against the US dollar.

This display of impotence brought a scathing editorial comment from the London-based *Financial Times* on Tuesday.

"Strong opinions," the editorial began, "are safest when they cannot be put into action. At their meetings in Washington the Group of Seven finance ministers and the governors of the International Monetary Fund mounted no defence of the dollar—which they might just have the power to arrange—but demanded a faster rise in the Chinese renminbi, over which they have no power at all. It demonstrates the stalemate in the international financial system."

The fall in the dollar against the euro—it is now regularly trading at around $1.43 and above—is threatening European export markets and will have a major impact if it goes much lower. Meanwhile, US officials are not inclined to take action because the dollar's decline is providing a boost for American exporters in world markets.

However, this policy could have major repercussions if foreign investors in US financial assets decide that they cannot to sustain losses on their dollar holdings and begin to liquidate them. With the US financial system dependent on an inflow of around $2 billion a day from the rest of the world, such a process could set in motion what has been dubbed a “nightmare scenario”—a run on the dollar that sends interest rates up and brings a major recession to the US economy.

In a speech on Sunday, former US Federal Reserve Board chairman Alan Greenspan said that the decline of the dollar may reflect a growing unwillingness of the part of foreigners to buy US securities.

“Obviously there is a limit to the extent that these obligations to foreigners can reach,” he said, pointing out that the dollar’s decline to its lowest level since 1997 may be “an indication that America is approaching this limit.”

Greenspan’s warning came after the US Treasury reported that international investors had sold a record amount of US financial assets in August. Total overseas holdings of US equities, notes and bonds fell $69.3 billion for the month after an increase of $19.2 billion in July.

The dangers were further underlined by outgoing IMF managing director Rodrigo de Rato. “There are risks that an abrupt fall in the dollar could be triggered by, or itself trigger, a loss of confidence in dollar assets,” he said.

The G7 meetings were dominated by the growing sense that a series of economic problems, which have been building up over the past decades, are now coming to the surface. However this sentiment is accompanied by an increasing unease that right at the very time when a co-ordinated response is needed, the IMF is unable to develop the necessary policies because of internal divisions.

A report in the *Financial Times* noted that central bankers were privately expressing the view that the current credit squeeze is just “the first of many disorderly episodes that will result from the huge trade imbalances that have emerged over the past decade. They have kept interest rates artificially low worldwide and encouraged reckless lending.”

According to the FT, comments by the outgoing Canadian central bank governor David Dodge expressed publicly what others were saying behind the scenes.

“This is precisely the time we need the fund’s ability and skills to deal with global imbalances,” Dodge said. But the divisions within the IMF meant that the chances of coming together with a common view on current policy had decreased.

“The longer the imbalances go on, the greater the risk that we will end with a rather messy denouement,” he warned.