# A TIME OF TRAVAIL

Melvyn Westlake

In this article from the London based SOUTH journal, Melveyn Westlake a leading economic analyst maintains that at heart of the fundamental problems of the world economy are the conflicting national interests of the biggest industrial powers of the capitalist world.

With share prices recovering from the great crash and signs of a revival in production, Republican President Herbert Hoover was able to declare on 1 May 1930, that "we have passed the worst". As a prediction, it could not have been more wrong, coming on the eve of the first of three banking crises that contributed significantly to the severest economic depression this century.

Reassurances from leaders of the big industrialised countries will be a feature of the next few months as they try to limit the damage of the latest financial collapse. But, as in the inter-war years, the financial upheavals are a manifestation of far more fundamental problems in the world economy. Unless these are tackled with a degree of skill and cooperation that has proved beyond governments in the past, a severe recession is inevitable.

At the heart of the matter are the irreconcilable national interests of the three biggest industrial powers of the capitalist North – the US, Japan and West Germany. The tensions reflect the collapse of US economic hegemony, and the emergence of Japan as a rival power, although still reluctant to take up the responsibility that entails.

The parallels with the inter-war years are striking. Then it was British hegemony that was waning, as the country struggled against a loss of industrial competitiveness and mounting financial difficulties. It was the largely self-sufficient US that had structural surpluses on its trade and refused to accept the international responsibilities that its new economic power demanded.

At that time, too, the tangle of war debts and German reparations forced countries into fierce export competition and restrained imports, sending deflationary impulses through the world economy. Today, the Third World's trillion-dollar debt burden is no less a millstone round the neck of international trade.

A sudden sharp reduction in the supply of new capital has also been a feature of both periods. After 1927, the capital outflow from New York and London – at the time, the two biggest lenders – to the rest of the world began to dry up. This helped to trigger a debt crisis that resulted in almost 80 per cent of all outstanding loans to Latin America being in default by the mid-1930s. The debt problems of developing countries in the 1980s have similarly been magnified by a collapse in the flow of new commercial loans. Investment capital has instead been going to finance the US trade deficit.

Deregulation in the 1920s also set in motion a financial whirligig that, as in recent years, bore little relationship to the real world of production and employment.

In our time, the explosive growth in financial transactions, again stimulated by deregulation, has reduced standards and spawned junk bonds, corporate raiders, leveraged buy-outs and a raft of other dubious instruments and practices that produce profits for financial manipulators but have little connection with the value underlying productive assets. The daily movement of funds across the foreign exchanges is more than US$200-billion, about 20 times the daily value of world trade in goods and services.

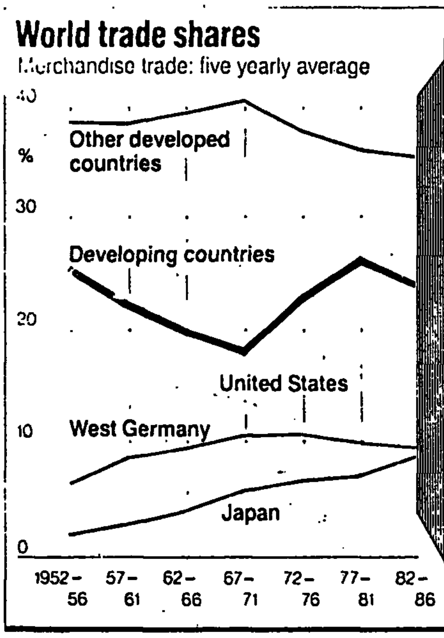
Financial institutions have been badly weakened by the fall in the quality of their assets. In 1974 about 16 US banks enjoyed a triple-A rating; by early 1987, this was down to one.

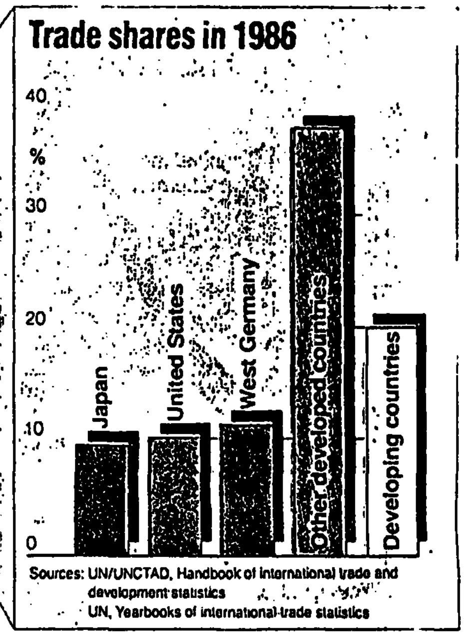
Meanwhile, as in the 1920s, many sectors have not shared the rise in prosperity. Agriculture is depressed, as in the earlier period. Tax cuts for the richest have caused an increasing concentration of income and wealth in the US as they did in the 1920s. And, as living standards drop in Africa and Latin America, the increasing concentration of income is evident on a global scale, intensifying deflationary forces.

Poor countries and poor people within rich countries tend to spend all their income. This creates demand for goods and keeps others employed. Rich people save more of their incomes. If these savings are not used for investment in productive enterprises like factories, they will fuel speculation in financial assets instead. This is why there was so much liquidity driving up share prices.

But in the meantime, the drop in the international buying power of developing countries has probably reduced output, cumulatively, in the North – through loss of exports – by up to one percentage point. This is quite significant when its growth is only 2 to 3 per cent a year.

All these financial and trade pressures point to an increasingly destructive rivalry to sustain or expand the production of goods at a time when there is less money to buy them.




Only the US, last of the big spenders, has prevented global demand collapsing, by settling its bills with other people's money. By normal standards, the men from the IMF should have moved into the US treasury a long time ago. But even the US must eventually face the reckoning. The trouble is that its US$35-trillion economy accounts for such a large slice of world trade that when it curbs spending, everybody is affected.

This is the dilemma. If the US administration slashes its budget spending enough to reduce the trade deficit significantly – lowering demand for imported goods and freeing resources for exports – the result will be recession. And if it does not, the dollar will fall, interest rates will rise, and there will be recession anyway.

In all probability, any successful effort to bring the trade accounts into closer balance would involve both a dollar devaluation and an austerity programme of government and private spending cuts – the usual IMF combination for developing countries in this type of situation. There is no certainty that either measure alone would bring about the necessary shift in resources. The connection between the two US deficits is nothing like as direct as sometimes suggested.

If all this makes a recession unavoidable, the only questions are when and how severe. A modest 1.5 to 2 per cent growth is forecast for the industrialised countries in 1988 by many economists. In all probability, we will see a further progressive weakening of business activity later in 1988, although short-term policy adjustments in Washington, Tokyo or Bonn might ward off recession until 1989.

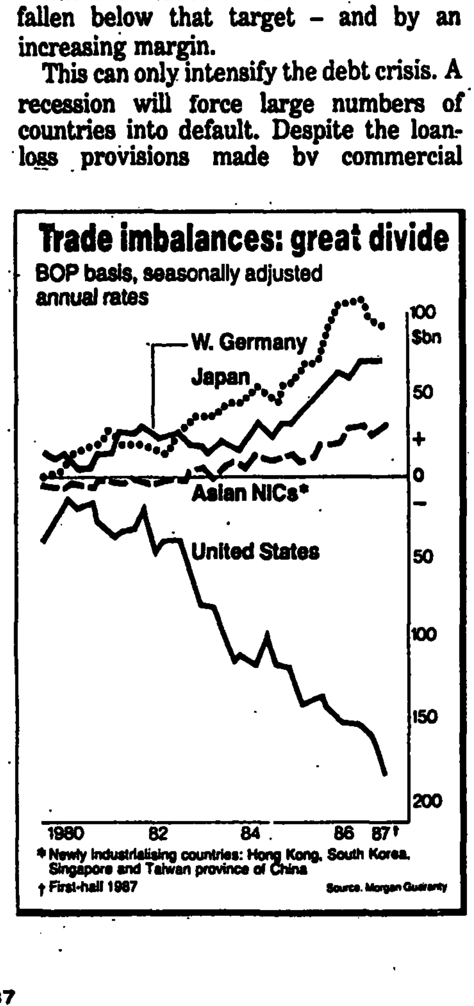
Its severity will depend on the precise conjuncture of events. A minimum growth rate in the North of 3 per cent is said to be necessary to enable developing countries to go on servicing their debts and still experience modest growth of their own. This will be the third consecutive year in which the industrialised countries have fallen below that target – and by an increasing margin.

This can only intensify the debt crisis. A recession will force large numbers of countries into default. Despite the loan-loss provisions made by commercial banks, many will be at risk. If a series of financial crises coincided with falling output and real incomes, and a breakdown in cooperation between governments, the result could be depression rather than recession.

In the US a recession is defined as two consecutive quarters of falling output. A depression is characterised by several years of falling or stagnant output, with unemployment up to 25 per cent. In developing countries, with their rising populations and rapidly expanding labour forces, even national income growth of 2 or 3 per cent could mean falling living standards and an explosive increase in the number of jobless.

The one hope government officials in some capitals have of avoiding a recession is to browbeat the West Germans and the Japanese into fuelling their economies to take over the role of locomotives, pulling along the rest of the world. But this underestimates the extent of structural problems. In the first place the scope for the two "surplus" countries to expand is quite limited. The West German population is falling by 3,000 a week, and its market is saturated. The West German people appear to want further improvements in their living standards to take the form of better environmental care rather than more goods. They produce more than they consume, which is why they have a large trade surplus.

Japan's workforce will have to support an increasingly disproportionate number of elderly people, for whom it must make provision now. If either country stimulates its economy further, it will have to increase its own budget deficit. At best, these bigger deficits can be no more than temporary, and there is the risk that



boosting deficits and then cutting them again will have a destabilising effect.

On some calculations, Japan's budget deficit is already proportionately bigger than the one in the US that is causing so much trouble. The only difference is that the Japanese save enough to finance it and US savers do not.

It is far from clear, anyway, how much an increase in Japanese and West German consumption would help the US. According to some calculations, even if they doubled their growth, it would not cut more than a few billion dollars from the US$160-billion US trade deficit. The main beneficiaries could be the newly industrialising countries of East Asia, which are anxious to increase exports to Europe and reduce dependence on the US market.

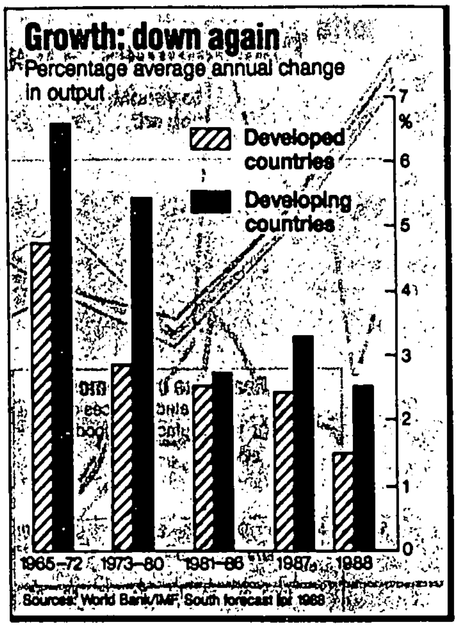
The extent of the loss of US international competitiveness is not fully appreciated. The high dollar had a severe impact on US manufacturing industry and forced companies to move overseas. Many export markets lost as the US de-industrialised will never be regained. Its lead in many hi-tech sectors has diminished or disappeared: semiconductors, computer hardware and software, fibre optics, robotics, airframes. In 1986, for the first time, it ran a deficit – of more than US$2-billion – in hi-tech manufactured goods.

In the early 1950s, its share of world merchandise trade was around 18 per cent. By 1986, this had fallen to 10 per cent, and Japan, which had a share of between one and 2 per cent 35 years ago, was on the point of surpassing the US. The decline in the US share took place, moreover, in a period when world trade expanded 22-fold.

The great difficulty in correcting theUS trade deficit is compounded by the adverse impact it will have on everybody else when it happens. US economist Lester Thurow reckons it takes 4-million full-time workers to produce US$160-billion of US manufactured goods a year. As a consequence, when the US dollar falls to a point where the trade accounts are balanced, the rest of the world will have lost at least that many jobs (partly offset by Germany's falling population).

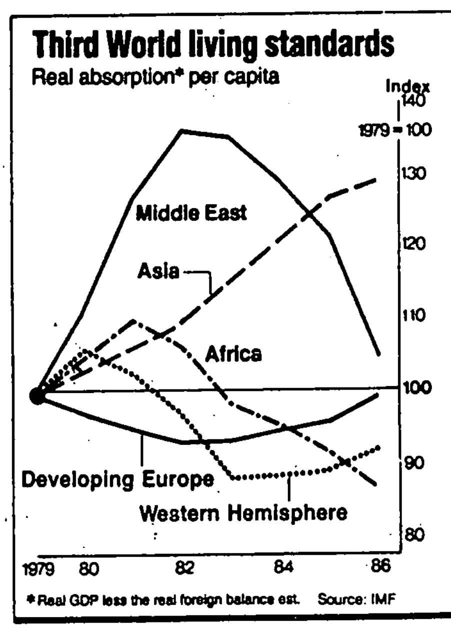
This is why, when the US trade deficit starts to shrink – as eventually it must – other countries will battle fiercely to hang on to markets. The trade war will hot up. And countries will jockey to hold down the value of their currencies to maintain international trade competitiveness.

The pain involved in correcting the US trade deficit has led many economists to question whether it is worth it. But there is no choice. How long will the world go on providing the US with US$10-billion to US$15-billion a month to finance its trade gap, when it already has a foreign debt which at US$400-billion is bigger than that owed by all of Latin America? The alternative is for the US to flood the world with dollars, creating serious inflation.




The reality is that a severe recession – or something worse – is probably the only way of eliminating the global imbalances. The books will be squared at a lower level of output, income and trade. In that case, the outlook for many developing countries is grim. The largest will be least effected. Those that depend on commodity exports will see prices and earnings fall further. Those that export manufactured goods will experience a drop in the volume sold overseas. Because the developing countries have learnt to live with much smaller levels of private financial flows than at the beginning of the decade, the IMF thinks that their output losses will be less than for the industrial countries in a recession.

In the early 1980s, a one per cent change in the North's output appeared to have an almost equal effect on the South.




This time, the link might be a little weaker. Even so, after years of only weak output growth, it will be a body blow. Export losses are likely to be concentrated among developing countries with the biggest debts. This, warned the IMF last September, would "seriously threaten the fabric of the debt strategy".

The impact of a recession in the North would also be especially marked among the low-income primary product exporters, it said, because they have few alternative uses in the short run for the resources employed in the export sector.

For middle-income countries much will depend on the policy responses of their governments. Some may have scope for switching output into the domestic market and promoting import-substitution. Alternatively, a recession in the North could give a fillip to trade between developing countries. During the recession of the early 1980s, such trade fell more sharply than the South's exports to the North.

But since then widespread policy reforms, currency devaluations and more efficient use of resources have created the potential for an expansion in South-South trade. It would be a considerable irony if the effect of IMF medicine had been to create the conditions for such an expansion. This however, will be made harder to achieve as long as debtor countries have to pile up trade surpluses to pay debt interest to the North.

Coming at a time when these countries will already be struggling to meet their debt bills, it will provide one more compelling reason to cease paying. The IMF, which has consistently been over-optimistic in its prediction about the Third World's future burden of debt relative to export earnings, was expecting some improvement in 1988 and beyond. It saw repayments and interest charges absorbing less than 20 per cent of the export earnings of capital-importing developing countries by 1991, compared with more than 27 per cent in 1986.

But this was before the global economy took its sharp turn for the worse last October. The worst combination for debtors would be lower export earnings and rising interest rates. In those circumstances the number of countries that stopped paying would multiply dramatically.

As it is, there is every likelihood that an increasing number of debtors will unilaterally impose limits on the proportion of earnings earmarked for debt payments. The idea of a 25 per cent upper limit is rapidly gaining respectability, while many countries in Africa and Latin America currently pay 40 per cent or more. Confidential calculations about African debt undertaken within the World Bank already routinely assume a 25 per cent limit. This limit will be adopted much more widely in 1988.

*Courtesy: South*