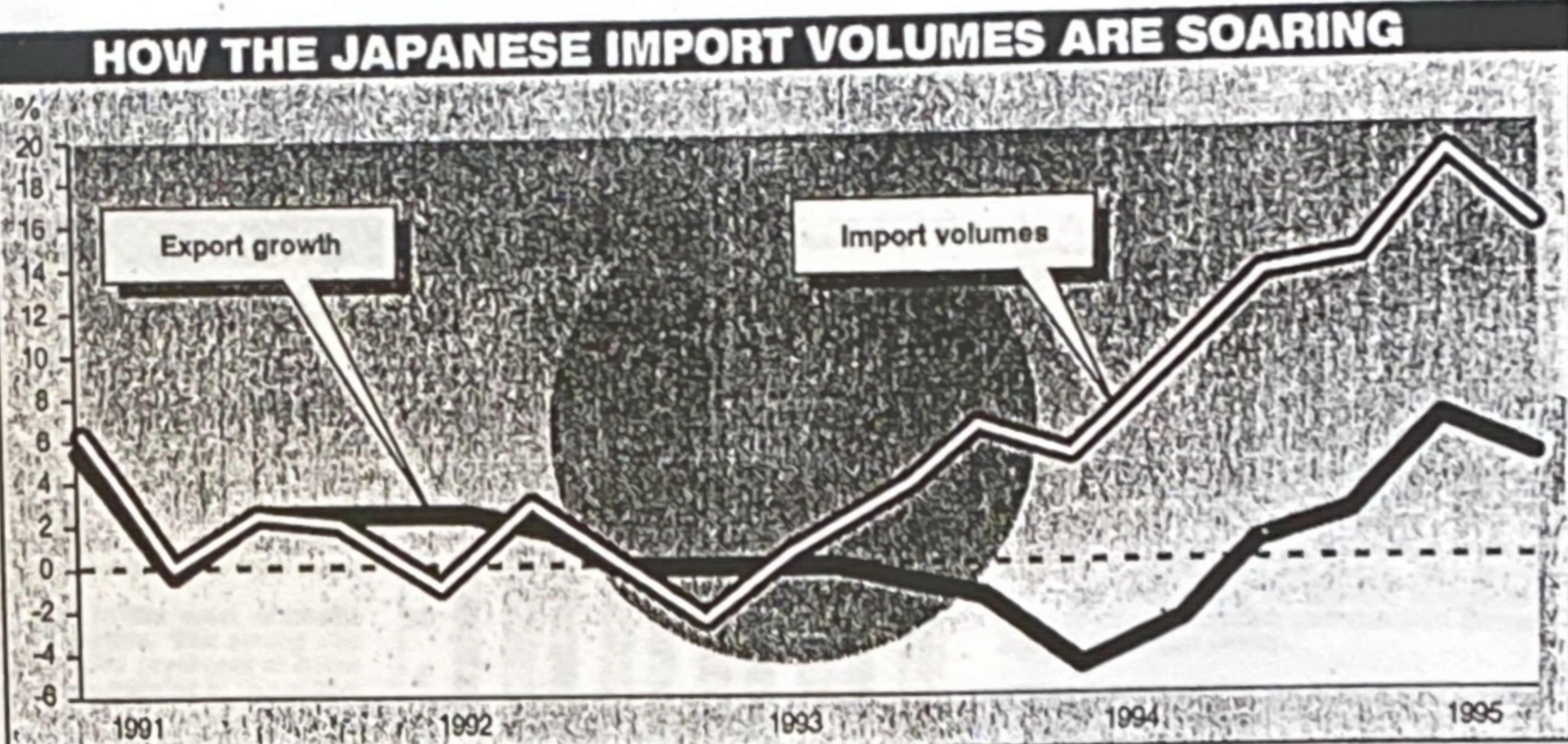
G7 fiddles while the dollar burns

ECONOMIC AGENDA

Gerard Lyons



It is about time the Group of Seven countries woke up. Last week the finance ministers and central bankers of the United States, Canada, Japan, Germany, France, Italy and the United Kingdom met in Washington. Even though the world's monetary system is undergoing one of its biggest shake-ups since the end of fixed exchange rates in the 1970s, the G7 did nothing. There was not one initiative to calm currency markets.

This is worrying. The dollar has tumbled against the mark and yen as investors have lost faith in US assets. Problems such as high budget deficits, the Mexican crisis and Barings have reinforced the flight to quality and safety.

The dollar may still be strong against weak currencies such as the peso but this is only because US investors have taken money home. This has reduced flows to emerging markets, flows that have been crucial for world trade.

The G7 should have produced credible steps to tackle the causes of the dollar's fall: a US commitment to cut its budget deficit; a US-Japanese agreement to cut their trade imbalance; and measures to boost confidence in the dollar, such as tough talk, intervention and interest rate changes in the US, Germany and Japan.

Instead, they played pass the parcel. The Europeans blamed the US budget deficit for the dollar's fall, while the Americans blamed Japan's trade surplus.

Countries should co-ordinate policy when it is in their interests to do so. There is a case to do so now because any further fall in the dollar against the yen and mark could cause severe problems.

Japan could be forced back into recession. Germany, the locomotive of Europe, could slow down. With sterling likely to be dragged lower by the dollar, this could lead to further British interest rate rises.

A dollar rebound could ease these problems. But even if bargain basement dollar buyers do come in, any currency stability may prove short-lived. By next year the dollar could be falling again. The longer-term trend suggests the emergence of three reserve currencies is already underway: the dollar, mark and yen. The G7's lack of resolve and the growth in intra-regional trade will see this continue.

Japan is the main victim of the currency shifts and its problems can effect us all because it is the biggest exporter of capital. This explains why the Japanese authorities are so concerned. Interest rates have been cut to 1 per cent and I believe they will remain low for the next two years, government spending is being boosted and the Bank of Japan sometimes appears to be the only central bank buying dollars, as it intervenes to stem the fall — but all to no avail.

The yen's strength is occurring at the worst time for Japan's economy. It already faces acute pressures because of the three Ds — deregulation, deflation and deindustrialisation.

Deregulation is opening up Japan's protected markets to foreign competition. Regulations in place since 1945 have succeeded in boosting industry but they are now seen as counterproductive, stifling competition, defending the status quo and preventing foreigners from selling goods.

For some time, Japanese firms have sold goods almost free from foreign competition. Thus in previous bouts of yen strength Japanese companies were protected from its impact. They could offset any export squeeze by selling at high prices and healthy margins in Japan. But all this is changing.

Deregulation is having two big consequences: deflation and deindustrialisation.

Opening up Japan is boosting imports and, in time, rising imports will cut the trade surplus. But in the short-term, competition is producing deflation, with prices falling. This is causing big problems. As firms cut prices, their margins are squeezed and this is forcing them to cut costs. As this continues, unemployment could rise.

This is prompting the biggest change, deindustrialisation. Faced with greater domestic competition, Japanese firms are shifting production to Asia's lower-cost countries. The desire to shift production fast has intensified, following the yen's surge and rising demand throughout south-east Asia. Germany faces similar problems in Europe, but on a smaller scale.

The irony is that deindustrialisation — or "hollowing out" — is initially boosting industry. As Japanese firms build factories elsewhere, they install plant and machinery made in Japan. This is boosting exports and output but in time production will be displaced to elsewhere in Asia.

Costs have always been low in south-east Asia. Whereas countries such as Singapore and Taiwan produced just low cost goods in the past, higher investment means they now produce high quality goods at low prices. Although south-east Asia has a small share of world trade, its importance is growing.

Just as Japanese investment has revitalised British industry it will reinforce the emergence of south-east Asia. Countries throughout the region are replicating Japan's success, investing in education, infrastructure and industry. Already Asia has exported low inflation to the rest of the world, forcing companies in the west to shrink, cut costs and invest to survive. This pressure will persist.

While Japanese firms will benefit from this shift, their economy will suffer. They will invest less in Japan and future growth rates will be weak by Japanese standards, adding to financial pressures.

Ironically, Japanese investors may provide the temporary solution to their country's own problem. Given the failure of the G7, it is up to Japanese investors to stop the dollar falling by recycling Japan's current account surplus into dollars. But why should they do this? In the past they lost money when the dollar fell. The same could happen again.

Fed up with losing money on foreign investments as other currencies weakened against the yen, Japanese investors have kept funds at home since last summer, buying bonds or staying in cash. Bond prices have soared. Japanese investors have not even been willing to buy Tokyo shares because of the economy's difficulties. But soon they may hunt for better returns and this could prompt shifts later this summer out of cash and into Tokyo shares and overseas assets.

Effectively the G7 countries are gambling. They hope currency markets will stabilise but they have done nothing to initiate this. Their hope rests with Far East investors. If they fail to buy the dollar it will collapse and global problems will intensify.

But even if they do buy the dollar, its future is in doubt. The G7's inability to act will accelerate its own demise and provide a signal of the global shift in economic power.

Gerard Lyons is chief economist at DKB International.

The Sunday Telegraph
Sunday 11 April 1995