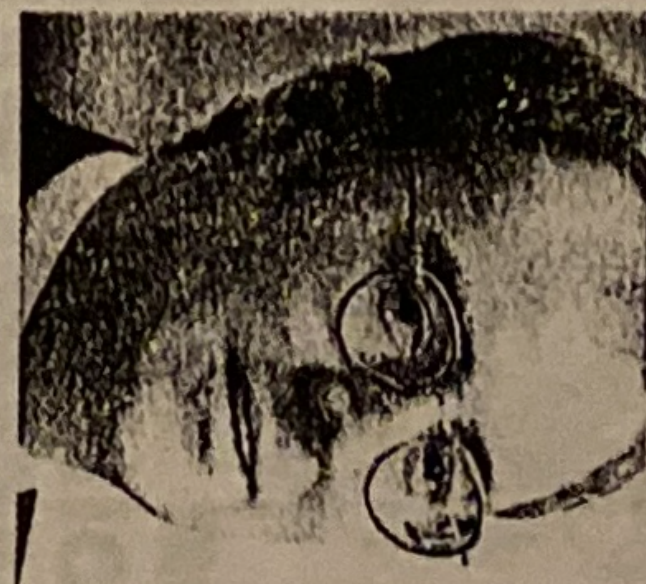
G7 should send a green light for the dollar



Yesterday's finance ministers' meeting in Berlin is unlikely to provide much of a global boost, says **Gerard Lyons**

The Bundesbank may never raise interest rates again! Europe's leading inflation fighter may have fought its last battle, as it is to be replaced by the European Central Bank at the start of 1999 and before then the weakness of the German economy will keep inflation as a dim and distant memory.

I am currently in Germany. The economy seems as sound and secure as on previous visits, and there is no evidence of any distress. The people seem happy and content. Yet the economic statistics tell a very different story. Nearly one in eight people are unemployed in Germany, with over one in ten out of work in the former west Germany. A further rise in unemployment appears inevitable, as German companies cut investment and jobs at home and move to lower-cost centres elsewhere.

Germany's generous benefits system may have lessened some of the misery but it is causing the government a headache, as it pushes the budget deficit up and lessens the chance of achieving the convergence criteria for European Monetary Union (EMU). Although political momentum in Europe still points to EMU beginning on time in 1999, the seriousness of Germany's economic problems means a last minute delay is still possible.

The prospects for EMU are likely to have been just one of the topics the finance ministers and central bank governors of the Group of Seven (G7) countries will have discussed yesterday when they met in Berlin. The G7 includes the largest industrialised countries, namely America, Japan, Germany, Britain, Italy, France and Canada. Yesterday's meeting was very timely, as the problems in the German economy should have helped focus attention on the difficulties facing the world economy.

Traditionally at G7 meetings policy makers congratulate themselves on their handling of the world economy and reaffirm their commitment to achieving steady sustainable growth, with low inflation. Clearly if things are going well then little needs to change. But the world economy is not in good shape, and has not been helped by inappropriate policies. Like World War I generals, many policy makers continue to fight yesterday's battle against controlling inflation, when the key worry is a lack of economic growth.

The US may be growing at a steady pace but it is not acting as a locomotive for the rest of the world. Japan's anaemic recovery is threatened by financial sector problems and higher taxes this spring. Clearly the economic picture on the Continent is not good. The German economy is in terrible shape and political obsession with the single currency is preventing sensible economic policies from being pursued throughout Europe. As a result EMU should stand for "Even More Unemployment".

Meanwhile, the British recovery has failed to gather momentum, not helped by the pound's strength and fears of unnecessary policy tightening. It is hard to imagine the G7 meeting triggering any change in policy thinking, although the Americans may have put some pressure on the Japanese to delay their tax increases.

G7 meetings rarely result in a change in domestic economic policies. If there is any impact it tends to focus on influencing the currency markets. Clearly, as our experience with the Exchange Rate Mechanism showed, exchange rate policies should not be at the expense of sensible, domestically orientated policies. But countries should co-ordinate policies when it is in their interests to do so.

The heyday of G7 was in the mid-Eighties, when co-ordinated policy helped weaken an overvalued dollar. Following the Plaza Accord in September 1985 policy was geared to pushing the dollar lower, and this was then followed by the Louvre Accord in early 1987 which helped stabilise the dollar at its lower level.

In the early 1990s the dollar again trended lower and this helped cure underlying trade imbalances. However, by spring 1995 currency movements had become destabilising and the subsequent weakening of the yen and DM has been fully justified and is likely to continue.

In the next few days the key issue is what message the G7 meeting has sent to the markets regarding the strength of the dollar. There is always the possibility of currency intervention, but if it occurs it is more likely to be aimed at controlling the pace of the dollar's appreciation, rather than reversing it. The reason for this is that a stronger dollar is in the best interests of the three main economies, America, Japan and Germany.

The weakness of recent domestic data in Germany, particularly the large rise in unemployment, highlights the need for a further competitive boost from a softer DM. A stronger dollar is also politically attractive for European governments who wish EMU to proceed on time.

A weaker yen is also good news for the Japanese, as it has helped relieve pressure on their manufacturing sector, giving the stock market some support. Despite this, the Japanese authorities appear keen to stabilise the dollar, as they fear its recent appreciation will eventually be reversed, and in order to avoid such currency volatility they prefer stability. The Americans, meanwhile, appear content with a stronger dollar, as this encourages foreigners to buy US debt and helps ease misplaced inflation fears.

As helpful as a stronger dollar is, it is no substitute for the need for the major economies, particularly in Continental Europe and Japan, to tackle underlying structural economic problems and to aim policies at boosting domestic demand.

Dr Gerard Lyons is Chief Economist of Dai-Ichi Kangyo Bank (DKB) International