Macro Comment 10/12

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Is the G20 making an undesirable U-turn?

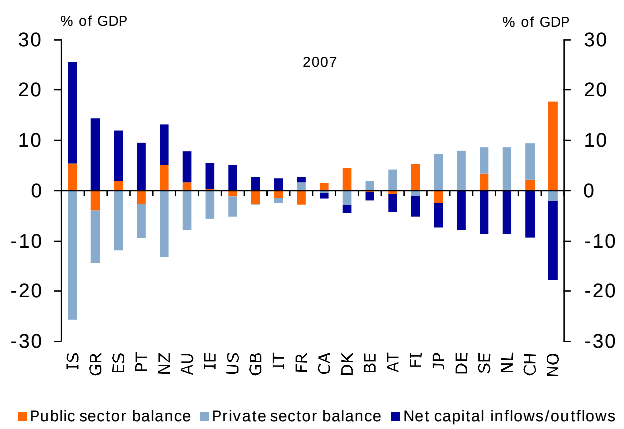
The finance ministers of the G20 have called for an end to expansionary fiscal policies in their latest communiqué. This can prove costly while households and firms are still (i) busy repairing their balance sheets and (ii) facing massive headwinds. Therefore, a synchronous exit from loose fiscal policies might risk pushing the OECD economies back into a recession and lead to worsening of public finances. To overcome this undesirable scenario, governments that still have some fiscal room to stimulate their economies must use it until the recovery is secured.

The finance ministers of the G20 have taken a strong U-turn from their previous policy proposal. The recently released communiqué of the meeting made it clear that the world leaders no longer thought that expansionary fiscal policy was sustainable or effective in fostering an economic recovery because investors were no longer confident about some countries' public finances. This message was in marked contrast to the G20's previous communiqué from late April, which called for fiscal support to "be maintained until the recovery is firmly driven by the private sector and becomes more entrenched". Even stimulus champions such as the head of the IMF have jumped on the bandwagon. Now the question is whether our world leaders have got it right to remove the stimulus that doesn't matter much for the increase in debt ratios according to the IMF? Of the almost 39%-points of GDP projected increase in the debt ratio of advanced economies between 2008-15, about one-tenth is explained by fiscal stimulus measures. Or are they right to react to the latest developments in the European bond markets to prove their resolve in restoring order to the public finances? In our view, the policy proposal of the deficit hawks may have undesirable effects if it strangles the recovery at birth. This fear is very much shared by Timothy Geithner, the US Treasury Secretary.

Private sector frugality resulted in public sector profligacy

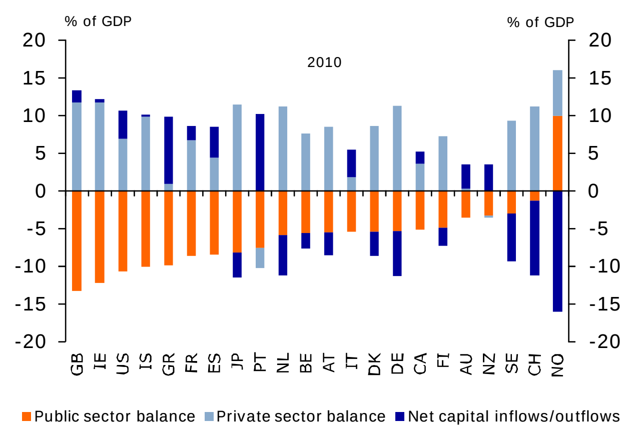
To fully appreciate the reason why we do not fully back this *one-size-fits-all* proposal, it is best to look at the sectoral financial balances of the OECD countries in 2007, before the crisis, and 2010 (OECD forecasts). Note that the balance between income and expenditure in the private, public and foreign sectors *always* sum to zero by definition. In figure 1, we can see that the private and public sectors of Greece, Portugal, Italy, the US, and the UK were living beyond their means in 2007 (i.e. this could only be made possible by substantial foreign capital inflows). Once the overextended private sectors retrenched, governments decided to fill in the spending gap by running sizeable deficits (see figure 2). The authorities could not afford to stand on the sidelines since it would result in a colossal contraction of aggregate demand – as we learnt all too painfully in the 1930s. The result of this Keynesian experiment was simple: an economic catastrophe was successfully averted thanks to the massive re-leveraging of the public sector.

Figure 1: Overstretched private sectors...



Source: Rabobank, Reuters EcoWin

Figure 2: ...forced the governments to step in



Source: Rabobank, Reuters EcoWin

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The G20 makes a (dangerous) U-turn

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So what would the policymakers achieve now by pressing hard on the brakes? They hope that the recovery will not lose momentum due to three reasons. First, consumers are thought to base their consumption decisions to some extent on expected future income streams (permanent income) rather than on current disposable incomes. In this context, GDP growth may even rise during the austerity period if consumers start spending more in the expectation of lower taxes in the future (this is known as the *Ricardian equivalence effect*). But it is difficult to estimate how much consumers will spend extra when their current purchasing power is being severely eroded by the austerity measures. Given that consumers still need to go through the painful process of repairing their balance sheets, expecting them to step in when governments exit might be too much to ask. This will keep firms' retained earnings in check, which will act as a drag on private investment. Second, governments hope that a credible consolidation programme can anchor the expectation of financial market participants. The reduction in risk premia on government securities amid credible belt-tightening measures can result in falling interest rates for the private sector, which will have positive effects for the entire economy. This will certainly hold true for debt-stricken Southern European countries. But the major industrialised countries may benefit less unless one expects that interest rates will rise sharply in the coming years amid sovereign default fears. Note that long-term interest rates might fall more against the background of falling inflation rates. Third, fiscal policymakers believe that even if the private sector faces difficulties in standing on its own feet, then a robust external demand can still manage to pull the economy out of the mess. However, the synchronous and premature exit of governments from loose fiscal policies shows that this can be a bit of wishful thinking (see Economic Quarterly Bulletin 2010/06).

Please do not shoot yourself in the foot!

Against this backdrop, we do not advocate governments heading for the exit hastily while the global recovery remains tepid. The entire policy proposal may backfire as austerity measures at a global scale may reduce GDP growth for all countries and cause debt ratios to further spiral out of control. This can even result in higher interest rates as bond vigilantes become more nervous about debt sustain-ability in the OECD. Debt dynamics will, therefore, become even less favourable going forward. That said, the current expansionary fiscal policies cannot remain in place forever either. Debt ratios are certainly on an unsustainable trajectory and the upcoming ageing-related expenses will only make matters worse.

So what could be the policy remedy? It differs per country. Those countries that still have a fiscal room (i.e. relatively low debt ratios and smaller structural deficits that is primarily financed domestically) must still use it in the short-run, in our view, to ensure the private sector recovery is self-sustaining. That said, concrete and credible medium-term fiscal consolidation programmes must be announced immediately to keep the financial markets calm. This policy is obviously not possible for the European periphery as they are already suffering from a loss of confidence. What's more, the current account surplus countries (e.g. China and Germany) must do more to boost demand at home in order to ensure global economic growth does not lose momentum (see Rabobank outlook 2010: Globalisation at a cross-roads). This will also make the upcoming fiscal adjustment less painful for those that are already exiting. Finally, the introduction of structural reforms that can boost nominal GDP is absolutely essential for all countries. The IMF's calculation shows that a 1%-point increase in growth for 10 years (assuming a 40% tax rate) lowers government debt by a whopping 29%-points of GDP. This can help reverse the adverse debt dynamics up to a certain extent.

The arguments provided above suggest that chocking the nascent recovery by exiting too early might be undesirable. We should realise that without economic growth, fiscal consolidation will become more painful. As such, striking the right balance fiscal consolidation and economic growth is of utmost importance. But always subject to the binding constraint that the fiscal position allows for this room to maneuver.

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