Forget austerity? Not completely, say economists

Lack of trust, lack of confidence, lack of visibility. Which way out of the world economic recession? Cut back or spend more or...?

While Greece has stepped back from the brink, averting at least temporarily a threatened collapse of the euro, the struggle to rein in rising government deficits continues across Europe. In the United States, a ballooning federal budget deficit is accompanied by an expanding current account deficit that is pushing ever more dollars into other countries' reserves.

But the most challenging deficit of all in this sea of red ink can't be measured in dollars and cents: it's the deficit of confidence that has hit the global economy, pushing up unemployment and consigning young people in many countries to the threatened fate of a "lost generation".

Euro crash or no, after more than three years of austerity that has failed to rebalance major economies, the only way to restore confidence is to rekindle growth with policies to stimulate demand, says INSEAD Professor of Economics Antonio Fatas.

"When economies are not growing, it is impossible to find a balance for anything," he asserts. "The most urgent thing now is to restore confidence, demand and growth."

Confidence "is the key word," echoes Pier Carlo Padoan, deputy secretary general and chief economist of the Organisation for Economic Cooperation and Development (OECD) in Paris. Choosing his words with care, he insists in an interview with INSEAD Knowledge that deficit countries must not abandon their efforts to reorder their economies, but makes clear that "we need to find a balance between fiscal tightening, consolidation and growth in the medium term." But how?

Joining the consensus

In May, the OECD caught the attention of financial markets by joining a growing consensus of politicians and economists in favour of government issuance of so-called Eurobonds, or debt instruments jointly issued by governments of the countries using the euro, as a possible way out of the euro crisis. Though they would provide no magic solution to Europe's economic woes, Eurobonds backed by all euro area governments would enable individual nations to raise money at lower cost, easing their budgetary difficulties. The funds could be used to rebuild banks' balance sheets and finance infrastructure projects, helping to boost growth in Europe's recession-weakened economies.

For the moment, the plan, which would mean partial collectivisation of individual countries' debts, is still under discussion at the level of European governments. Though supported by France and

Italy, it has been rejected by Germany on the grounds that it would weaken pressures on individual countries to put their finances in order. In February, Deutsche Bundesbank board member Andreas Dombret warned of "overwhelming moral hazard problems" if countries that have behaved irresponsibly are able to escape from their problems without punishment.

Given the plight of the world economy, however, such misgivings strike many economists as misplaced. "You worry about the moral hazard in the long term," says Fatas. "We're in a massive recession that can turn into a depression, and we need to fix that first."

Falling off a fiscal cliff

In the U.S., a weak economic recovery has been further hampered by falling house prices. Unemployment remains high, while a squeeze on public funding poses what Padoan describes as the second biggest risk for the global economy. As the U.S. government heads into its fourth year of trillion-dollar-plus budget deficits amid on-going Congressional wrangling about taxes, it is likely to hit a threatened "fiscal cliff" in the form of a US$16.4 trillion self-imposed borrowing limit later this year or in early 2013, potentially forcing it into default unless Congress agrees to raise the debt ceiling – a contentious issue in this presidential election year.

Further afield, even China caused a brief flurry earlier this year with news of an unexpectedly sharp trade deficit in February, reversing its usual pattern of strong trade surpluses. Though the February deficit turned out to be temporary, with subsequent months showing a return to surpluses, signs of a slowdown in Chinese economic growth have prompted concern in Europe and the U.S.

On the positive side, Padoan notes that reforms in many countries are already under way and could produce results faster than many people expect. As for China, despite signs of a slowdown, "what is happening in China is actually welcome," he says, because growing domestic demand and consumption have already produced a narrowing of China's current account surplus and a redistribution of demand towards domestic sources. In June, Chinese authorities relaxed interest rates and lending conditions to help maintain domestic demand. This is "good for China, good for the Chinese consumers, but also good for the global economy because it addresses one of the issues, global imbalances, which has been very much at the centre of the policy debate," Padoan says.

The issue is trust

But the crisis hitting the euro area is problem number one. "The euro area is in a mild recession but with diverging speeds between north and south," says Padoan. "This is a general problem which could spill over into the global economy. The debate about Eurobonds has become a proxy for arguments about how to stave off the collapse of Europe's common currency. At its heart is the issue of trust between European governments and the challenge of creating a fiscal union to support the continent's troubled monetary union: "the old problem of Europe," says Padoan.

Lack of trust underlay the European Union's 1997 Stability and Growth Pact penalising annual budget deficits of more than 3 percent of gross domestic product (GDP) and setting a limit of 60 percent of GDP on national debt -- levels that have now been vastly exceeded, he points out. Today, solving the euro area crisis "is not only about … addressing the emergency, but also about building a really sustainable monetary union for the long term," he says. Unless governments can overcome "the poison of lack of trust … we will never solve, once and for all, the crisis."

So what will it take? First of all, as trading losses at JPMorgan Chase & Co. and the crisis affecting Spanish banks have shown once again, there are still major and widespread problems in the banking sector that must be addressed. Restoring confidence in the banking system requires "banks' balance sheets (to) be transparent, even if they show losses," says Padoan. "And once losses are certain then banks need to be recapitalised."

In the U.S., too, even though "the political climate is strongly opposed to any further bailouts of banks … everybody knows that the ultimate outcome has to be a renegotiation or a write-down of the debt," James K. Galbraith, Professor of Government at the University of Texas, Austin, told INSEAD Knowledge. Recapitalisation, he adds, will most likely have to be accompanied by some restructuring of the banking sector, involving not just tighter regulation and tighter supervision but also restrictions on size.

Downsizing the financial sector

The U.S., in particular, will have to address the question of "whether we need to have a financial sector in the economy going forward which pays 10 percent of wages and earns 40 percent of profits," Galbraith says. "We didn't have that 20 years ago, and it is not clear that we will again soon be running the economy through the conduit of these particular institutions."

At a broader level, there's a growing consensus that governments must take action to boost demand and stimulate growth. This was the theme of a recent meeting in Rome between newly-elected French president François Hollande and Italian care-taker prime minister Mario Monti. Even though focusing on growth does not mean abandoning efforts to contain public budget deficits, Monti told journalists after the meeting, "Public account discipline is not enough to have growth, foster development and create jobs."

To be sure, switching policies to growth mode is easier said than done in deficit-weakened countries like Italy and Spain. Greece, meanwhile, faces continuing pain, even if a new governing coalition succeeds in moderating the terms of bailout support for its economy from the European Union and the International Monetary Fund.

In France, parliamentary elections have given Hollande a clear mandate for measures that he claims will encourage growth. His plans have been criticised by German chancellor Angela Merkel, who has demanded fiscal union between euro area countries as the price for action. But many economists feel that Germany needs to act faster than negotiations over a possible fiscal union would allow.

Rebalancing Europe

"Europe needs rebalancing," Padoan affirms. "This is an issue with both the southern countries, where competitiveness needs to be boosted, and northern countries, where wages could rise and supporting demand and reforms could further enhance growth prospects, including in Germany."

Among structural reforms, he calls for a deepening of Europe's Single Market, which he says "would add growth opportunities everywhere in the world". But he also favours investing in infrastructure through an enhanced role for the European Investment Bank, better use of structural funds at the European level and the gradual introduction of jointly guaranteed bonds on the Eurobond model.

Such a combination "would launch growth on a stronger path in Europe in the longer term," he says. "The issue is redistribution of efforts and contributions and gains within Europe."

Can European countries afford to take such action? Emphatically yes, say both Padoan and Professor Fatas.

"These are the richest countries in the world," says Fatas. "They just need to have the political will. We need more demand, and the only way to get it is not to force every government to go for more austerity."

Germany has done well out of the euro and it would lose a lot from a slump in southern Europe and the euro's collapse, he says. Though adjustment to reduce public sector deficits and current account payments imbalances is also needed, "it needs to be done slowly." The alternative of pressing ahead with rapid coordinated adjustment, he warns, threatens to "kill the world economy."

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