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No time for Wayne's pea and thimble

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Illustration: Eric Lobbecke Source: The Australian

ON October 9, 2007, the New York Stock Exchange's Dow Jones index reached its all-time high of 14,164.53. Almost exactly five years of turmoil later, the International Monetary Fund's recently released World Economic Outlook warns that the "risks for a serious global slowdown are alarmingly high". With world trade virtually stagnant in recent months, the fund has downgraded its assessment of global economic prospects, while hedging even that projection with a chilling litany of possible downsides.

However, the dangers the world economy faces are not narrowly economic. Rather, the gravest risk is that of political backsliding on tackling entrenched structural problems. As the IMF's gloomy prognosis unleashes calls for further sugar hits to world growth, the pressures to go soft on reform programs have reached new peaks. But succumbing to those pressures would merely postpone the reckoning, making its costs even greater.

Whether the fund's pessimism about the short-term outlook is well-founded remains to be seen. China's slowing may have reached a plateau, and while full recovery is still a way off, the US seems to be in a gradual but broad-based expansion, with unemployment falling in virtually all states. But even with those reasons for cautious optimism, Europe's prospects are undeniably grim.

This is partly a matter of some unpleasant arithmetic. Underpinning the IMF's analysis is the fact that to reduce the ratio of public debt to GDP without fiscal belt tightening, the interest rate on that debt must be less than the economy's growth rate. Conversely, when interest rates greatly exceed growth rates, reducing indebtedness requires running large and possibly growing budget surpluses, generating the revenues required to meet interest payments and redeem outstanding debt. And while the European Central Bank's bond-buying operations have reduced European interest rates, GDP growth rates have fallen as much or more.

As a result, debt-GDP ratios continue to rise, creating the risk of a vicious cycle. Like a Ponzi scheme in reverse, greater fiscal austerity would chase the tail of a debt-stabilisation target which its own growth-depressing effects would make it impossible to achieve.

But even if one accepts the fund's analysis, the question must be why fiscal consolidation is exacting so high a price in terms of reduced GDP. The answer lies in labour market regulations that have prevented real wages in the euro zone from falling in response to mounting unemployment. With employing labour no more profitable, the

private sector has lacked the incentive to absorb workers made redundant by public spending cuts.

And compounding the problems are tax hikes that have increased the costs of doing business, and spending cuts that have done little to improve the quality of public expenditure.

Italy is a case in point, with the administration of Mario Monti quickly losing its gloss. True, Monti has loosened draconian restrictions on redundancies, but he has shied away from reforming the publicly financed layoff scheme that subsidises inefficient firms and keeps unemployed workers out of the labour market.

As for curtailing public spending, a much touted expenditure review is not only well behind schedule but so far has mainly handballed the difficult choices to Italy's regions. And like its predecessor last year, a proposed increase in value-added tax seems set to merely shift activity into the still growing black economy, where wages are flexible and taxes, paid in the form of bribes, low.

Little wonder then that while the ECB has succeeded in reducing interest rates on short-term Italian government bonds, long-term interest rates have declined much less: immediate threats of insolvency have eased, but markets believe the crisis has been deferred, not averted. And should that crisis break out, potentially in the lead-up to general elections early next year, neither the newly established European Stability Mechanism nor the ECB has the means to deal with it.

To make matters worse, the danger of provoking such crises is no longer limited to southern Europe. Rather, France is shaping up as the euro zone's next major trouble spot, as the pledge to cut its budget deficit and bring a gross debt to GDP ratio of nearly 90 per cent under control collides with a sharply slowing economy and a socialist government intent on destroying France's international competitiveness.

As the IMF acknowledges, simple-minded Keynesianism is no cure for the risks all this creates. Indeed, recent studies, including one sponsored by the Australian Treasury, suggest Keynesian nostrums have little positive effect even in economies where public debt is low. In countries where public debt is high and climbing, any attempt to restore growth through spending splurges would destroy fiscal policy credibility, triggering unmanageable sovereign debt crises. Instead, Italy, France and their euro zone colleagues must rekindle confidence in the commitment to budget consolidation and labour market reform.

But that has not stopped diehard Keynesians from seizing on the IMF's report as proof that austerity has failed. And the Obama administration has echoed their claims, with calls for Germany and China to "do more" to bolster world growth.

This is deja vu all over again. In July 1978, the Carter administration, rather than address the US monetary and fiscal irresponsibility that had plunged the world into stagflation, demanded Germany and Japan act as the "locomotives" for renewed growth. While Japan ignored US pressures, Germany agreed to a concerted stimulus that fuelled inflation while doing nothing to reduce unemployment.

Now as then, the US, instead of confronting its structural problems, is looking to others to paper over the cracks. And whoever wins the presidential election, those problems are formidable. With a structural budget deficit of 6 per cent of GDP, the US now relies on foreign inflows to finance all of its capital accumulation and a material portion of its current consumption.

Meanwhile, the Social Security Trust Fund is expected to be entirely exhausted by 2040, while the hospital trust fund, which pays for Medicare, is set to run out of resources in 2024.

Addressing problems of that magnitude requires leadership that goes well beyond the choices on offer, lacking, as they so plainly are, in essential political vitamins. Rather, much as in 1979, the world needs a renewal on the scale Ronald Reagan and Margaret Thatcher brought, with the courage to put everything on the table. Until that happens, the fund's dire warnings will ring all too true.

And nowhere should those warnings resonate more than here. For however great the global uncertainties, one thing is sure: Wayne Swan's pea-and-thimble tricks can no more give our economy the resilience it requires than Julia Gillard's Fair Work Act can make our labour market flexible in facing the dangers that lie ahead. With the IMF sounding the alarm, it's time for the opposition to explain how it will do better.