Give fiscal policy back its bite

Wayne Swan needs to do more to keep Australia out of the economic doghouse, writes **Stephen Anthony**.

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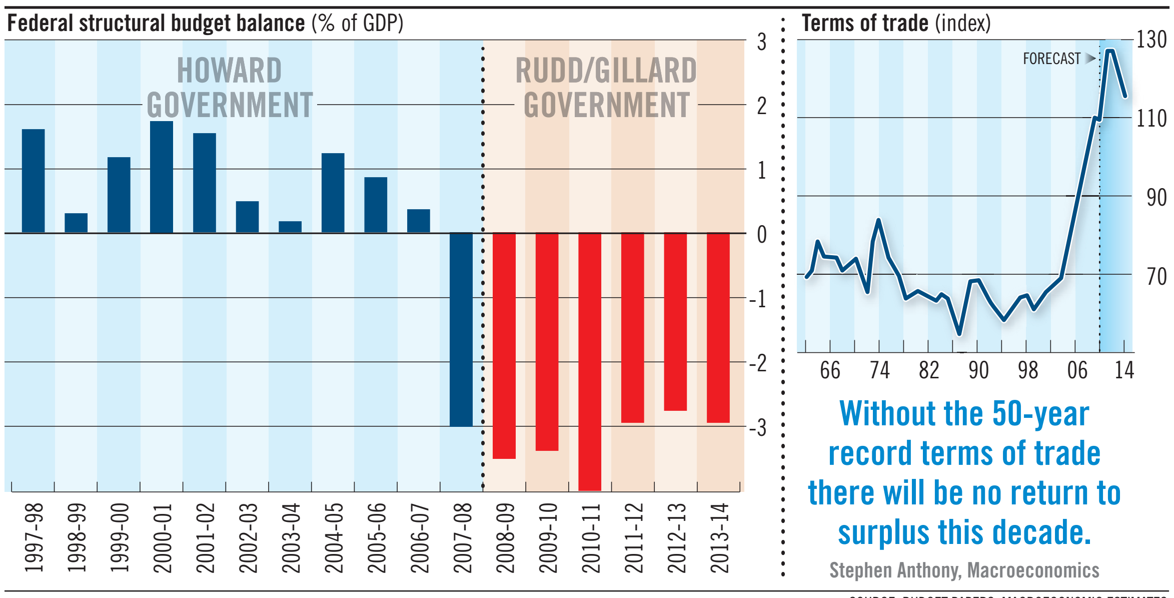

SOURCE: BUDGET PAPERS, MACROECONOMIC ESTIMATES

Australian governments have made much hay of their economic successes in recent years and relative budgetary performance. Macroeconomics' mid-year budget bulletin, released last week, reveals that had the economies of Great Britain, the United States or for that matter Greece, benefited from Australia's terms of trade over recent years, they would now be experiencing strong economic growth and much smaller budget deficits.

Had the Australian economy been exposed to those economies' terms of trade, we too would be in the economic doghouse.

Commonwealth budget and medium-term fiscal strategy appears to be built on sustaining a 50-year commodity price peak courtesy of China Boom 2. The headline underlying cash budget is expected to return to surplus in 2012-13, but will only do so and remain in surplus while the terms of trade stay at 50-year highs. Once commodity prices normalise, the budget will slide again into deficit. At that point the structural weakness of the budget will be evident.

The structural budget position is quite a mess. Our Commonwealth structural balance model suggests a structural cash deficit of $58 billion in 2010-11 (about 4 per cent of gross domestic product), and barely falling in dollar terms by the end of the forward estimates period when the budget is still expected to be in deficit by around $49 billion (or 3 per cent of GDP) in 2013-14.

The rapid deterioration in the structural budget position at the end of the Howard government is such a big problem that even the federal Treasury is now publicly expressing its concern. The large structural deficit is based on our assessment of long-term trend revenue streams, and is driven by movements around trend in real GDP and commodity prices.

Record commodity prices are contributing to windfall budget tax receipts which are contributing more than $30 billion to the underlying cash position over the forward estimates period. They underwrite the Gillard government's chances of returning to surplus. Without the 50-year record terms of trade there will be no return to surplus this decade.

To repair the structural deficit, Treasurer Wayne Swan has imposed a real spending cap of 2 per cent. But this cap cannot provide a quick fix to drastically improve the structural budget position in the short term, although we acknowledge that in theory it may work over time, assuming trend growth is maintained and governments stop spending. So far the unwinding of the global financial crisis stimulus has allowed the Commonwealth to easily achieve its 2 per cent spending target. But underlying real spending growth is running at 3.8 per cent, adjusting for the stimulus.

From 2010-11 on, the Treasurer won't be able to hide behind the GFC stimulus to achieve his target and so the benchmark will require real discipline.

The spending cap will come under enormous pressure in coming months as the era of minority government imposes new spending priorities (i.e. regional development, the environment, public infrastructure and Commonwealth-state relations) while doing nothing to reduce existing spending pressures from population ageing and defence weapons upgrades.

How have the Rudd and Gillard governments performed so far in terms of achieving genuine savings? By our reckoning, in 2½ budget rounds since coming into office, new net discretionary spending (including fixed assets purchases) totals $113 billion, including temporary GFC stimulus spending worth about $70 billion.

Former finance minister Lindsay Tanner has said the Rudd government's first two budgets contained $55 billion of savings initiatives over five years, and that the bulk of these were spending cuts, but this does not square with the expenditure reconciliation tables in Budget Paper No 1. These tables suggest a net increase in policy spending of about $43 billion over five years and no reduction in discretionary spending at all.

Much of the $43 billion increase in the permanent discretionary spending base has been devoted to increasing the age pension. While this is admirable for struggling pensioners, it is very irresponsible for those who are well off.

We reckon about $45 billion of the $70 billion in temporary GFC stimulus spending was wasted on uneconomic projects as we detailed in budget bulletins in 2009.

After the recession we never had, the Commonwealth has a structural deficit of about $58 billion in 2010-11 and faces the prospect of structural deficits for the rest of this decade and perhaps much longer, given that the baby boomers have now officially started retiring (1945 + 65 = 2010).

Fiscal strategy should be about building national savings to underpin the productive capacity of the nation over time and to fund "no regrets" policy measures in lean years. We estimate that China Booms 1 & 2 will add about $230 billion to federal tax receipts between 2004-05 and 2013-14, yet none of this windfall has been captured for a rainy day.

Don't forget the fiscal impact of the state and territory governments. They will collectively run structural deficits close to $9 billion in 2010-11 and will borrow to pay for infrastructure they neglected for two decades at the worst possible time in the business cycle.

Another way to reduce the structural deficit is to undertake an old-fashioned razor gang or commission of audit-style savings round. Discretionary tightening now would be perfectly timed to take the heat out of an economy straining under China Boom 2, while helping the government shore up its fiscal credentials.

Our structural balance measure suggests a fiscal austerity package of around 2-3 per cent of GDP or $30 billion to $40 billion over two to three years is needed.

This would require discipline and courage from the Gillard government. I can hear Sir Humphrey, "alas these traits, whilst admirable, may be somewhat lacking in today's leaders".

■ *Stephen Anthony is the director, budget policy and forecasting, at Macroeconomics and a former Treasury and Finance official.*

Competitive devaluations a path to trade wars

Countries with a surplus have an interest in aiding global rebalancing by letting their currencies rise, writes **Nouriel Roubini**.

The risk of global currency and trade wars is rising, and most economies are now engaged in competitive devaluations. All are playing a game that some must lose.

Today's tensions are rooted in paralysis on global rebalancing. Over-spending countries – such as the United States and other "Anglo-Saxon" economies – that were over-leveraged and running current-account deficits must save more and spend less on domestic demand. To maintain growth, they need a nominal and real depreciation of their currencies to reduce their trade deficits.

But over-saving countries, such as China, Japan and Germany, that were running current-account surpluses are resisting nominal appreciation. A higher exchange rate would reduce their current-account surpluses, because they are unable or unwilling to reduce savings and sustain growth through higher spending on domestic consumption.

Within the euro zone, this problem is exacerbated by the fact that Germany, with its large surpluses, can live with a stronger euro, whereas the PIIGS (Portugal, Ireland, Italy, Greece, and Spain) cannot.

On the contrary, with their large external deficits, the PIIGS need a sharp depreciation to restore growth as they implement painful fiscal and other structural reforms.

A world where over-spending countries need to reduce domestic demand and boost net exports, while over-saving countries are unwilling to reduce their reliance on export-led growth, is a world where currency tensions must inevitably come to a boil. Aside from the euro zone, the US, Japan and the United Kingdom all need a weaker currency. Even Switzerland is intervening to weaken the franc.

Meanwhile, China is intervening to resist appreciation of the yuan and thus maintain its export performance. As a result, most emerging-market economies are similarly worried about currency appreciation, lest they lose competitiveness relative to China, and are intervening aggressively and/or imposing capital controls to stem upward exchange-rate pressure.

The trouble is that not all currencies can be weak at the same time: if one is weaker, another must, by definition, be stronger. Likewise, not all economies can improve net exports at the same time: the global total is, by definition, equal to zero. So the competitive devaluation war in which we find ourselves is a zero-sum game: one country's gain is some other country's loss.

The first salvos in this war came in the form of foreign-exchange intervention. To diversify away from US dollar assets while maintaining its effective dollar peg, China started to buy Japanese yen and South Korean won, hurting their competitiveness. So the Japanese started to intervene to weaken the yen.

This intervention upset the EU, as it has put upward pressure on the euro at a time when the European Central Bank has placed interest rates on hold while the Bank of Japan (BoJ) and the US Federal Reserve are easing monetary policy further. The euro's rise will soon cause massive pain to the PIIGS, whose recessions will deepen, causing sovereign risk to rise. The Europeans have thus started verbal currency intervention and may soon be forced to make it formal.

Currency wars eventually lead to trade wars, as the US congressional threat against China shows.

In the US, influential voices are proposing that the authorities respond to China's massive accumulation of dollar reserves by selling an equivalent amount of dollars and buying an equivalent amount of yuan. Meanwhile, China and most emerging markets are accelerating their currency interventions to prevent more appreciation.

The next stage of these wars is more quantitative easing, or QE2. The BoJ has already announced it, the Bank of England (BoE) is likely to do so soon, and the Fed will certainly announce it at its November meeting. In principle, there is little difference between monetary easing – lower policy rates or more QE – that leads to currency weakening and direct intervention in currency markets to achieve the same goal. In fact, quantitative easing is a more effective tool to weaken a currency, as foreign exchange intervention is usually sterilised.

Expectations of aggressive QE by the Fed have already weakened the dollar and raised serious concerns in Europe, emerging markets and Japan. Indeed, though the US pretends not to intervene to weaken the dollar, it is actively doing precisely that via more QE.

The BoJ and the BoE are following suit, putting more pressure on the euro zone, where a stubborn ECB would rather kill any chance of recovery for the PIIGS than do more QE, ostensibly owing to fears of a rise in inflation. But that is a phantom risk, because it is the risk of deflation, not inflation, that haunts the PIIGS.

Currency wars eventually lead to trade wars, as the US congressional threat against China shows. With US unemployment and Chinese growth both at almost 10 per cent, the mystery is that the trade war drums are not louder than they are.

If China, emerging markets and other surplus countries prevent nominal currency appreciation via intervention – and prevent real appreciation via sterilisation of such intervention – the only way deficit countries can achieve real depreciation is via deflation.

That will lead to double-dip recession, even larger fiscal deficits, and runaway debt.

If nominal and real depreciation (appreciation) of the deficit (surplus) countries fails to occur, the deficit countries' falling domestic demand and the surplus countries' failure to reduce savings and increase consumption will lead to a global shortfall in aggregate demand in the face of a capacity glut. This will fuel more global deflation and private and public debt defaults in debtor countries, which will ultimately undermine creditor countries' growth and wealth.

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