THE CENTRE FOR INDEPENDENT STUDIES

TRANS-ATLANTIC FISCAL FOLLIES: THE SEQUEL

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CIS POLICY FORUM 21

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Introduction

Two engines of the global economy sputtered in late 2008—the United States and Europe. Serious banking crises there provoked major falls in economic output throughout 2009. Unemployment soared and equity markets collapsed. It was the worst combination of economic maladies since the Great Depression 80 years earlier.

The 'great moderation,' that short-lived halcyon era of economic contentment from the early 2000s, was decidedly over. The collapse embarrassed governments and the economics establishment, much of which had lauded banks' financial practices, as much as it sparked anger among ordinary people.

Governments, desperate to appear 'in control' of economies they had long claimed to 'manage,' revived Keynesian economic policies. Long-discredited after disastrous applications in the 1970s and 1980s, Keynesian ideas offered governments a way to 'take control' while ignoring the perverse incentives in financial markets that had fostered the crisis.

Governments in Europe and America borrowed on a massive scale to 'stimulate' their economies.

For a brief while in early 2010, it appeared to be working. The world economy was recuperating. Unemployment in the United States was falling again and Europe's unemployment rate had flatlined and started to decline.

But two years on, the global economy is again in the doldrums, but now with vastly more public debt—courtesy of the Keynesian revival.

A major debt crisis is in the offing in Europe, emanating from Greece, which is threatening swathes of the financial system with insolvency and the credibility of the euro currency itself. The United States, whose government enacted one of the largest 'stimulus' packages in 2009, is exhibiting increasing unemployment and grappling with a debt problem of its own.

Australia's economy has proved remarkably resilient. Buoyed by its trade ties with Asia, and enjoying prices for its exports at historic highs, Australia's employment statistics and economic growth have remained robust. Australia too implemented a massive 'stimulus' package in 2009, although economists will long debate the extent to which it kept the economy afloat.

Two years ago, The Centre for Independent Studies convened a forum to discuss the global and Australian economies in the wake of the major banking crisis of late 2008. We convened another in August 2011 to re-evaluate the world's economic directions, with a focus on Europe, the United States and Australia. Robert Carling, Oliver Hartwich, and I spoke at this event, and this CIS Policy Forum provides a record of those speeches.

All three of us highlight the follies of government policies, but we are not universally pessimistic. Indeed, Europe and America are becoming increasingly irrelevant to Australia's economic development and stability.

Adam Creighton
Research Fellow
The Centre for Independent Studies
Sydney
November 2011

Washington's Crisis of Government

Robert Carling

Something must be wrong if America's fiscal problems can make almost as much news in Australia's mainstream media as our own federal budget. People are talking loosely about a 'debt crisis,' but I argue that there is no debt crisis yet. Rather, there is a crisis of government reflected in a huge budget gap between expenditure and revenue, which if not corrected, will create a debt crisis in the future.

US federal government debt: Past, present and future

The US gross federal debt is approaching $15 trillion, or 100% of gross domestic product (GDP). Excluding debt that the government owes to itself (intragovernmental debt), the figure for 'debt held by the public' is around $10.5 trillion (or 70% of GDP). There are also state government debts and non-debt liabilities and contingent liabilities, which dwarf the debt liabilities, at both the federal and state levels.

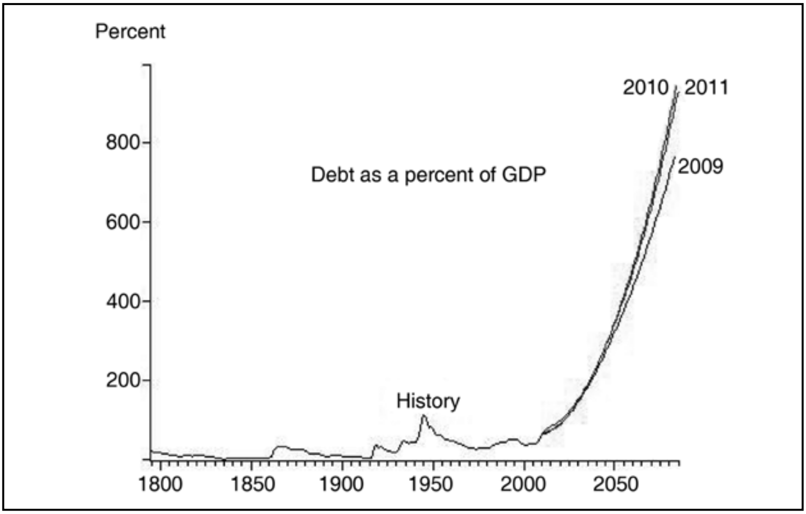
Historically, this level of debt was seen post World War II, after which it declined over many years to acceptable levels (Figure 1). Should we expect the same escape from high debt levels this time? I think not, because coming out of a world war and going into a long period of strong economic growth was a much more favourable set of circumstances than what prevails now. Instead of shedding the burdens of a world war, the United States is living with a financial crisis that is going to weigh heavily on its economic growth for years.

Deficits drive debt levels, and the US federal budget is in deficit this year to the tune of $1.5 trillion (or almost 10% of GDP). It has hardly improved from its highest level in the financial crisis. The Congressional Budget Office (CBO) and the International Monetary Fund (IMF) foresee some moderation in deficits over the next several years, even if economic expansion is only modest, but deficits will still be large enough to further increase debt as a percentage of GDP. Debt held by the public could reach 100% of GDP within 10 years.*

Beyond 2020, projected debt levels spiral upwards for two reasons: the cost of the public pension and health care schemes will increase rapidly as population ageing intensifies; the public debt interest bill will rise exponentially as ballooning deficits, debt, and interest payments feed off one another. The interest bill will eventually become the government's biggest expenditure program.

Underlying these long-term projections is a massive expansion in the size of the federal government from around one-quarter of GDP now (a peacetime record) to one-third by 2035 and over 40% by 2050. Thus, in a quarter of a century, the government/private mix in the US economy would resemble the 50/50 split that now prevails in many European economies, placing great upward pressure on the tax burden.

Figure 1: US federal debt since 1800 (% of GDP)



Source: John Taylor's blog, Economics One.

* The CBO has a 'baseline' set of projections and an alternative fiscal scenario. Under the baseline projections the debt burden would stabilise over the next few years, while under the alternative scenario it would continue to rise. Here, I draw on the projections under the alternative scenario because the assumptions are more realistic.

How much is too much?

Public debt is often expressed as a percentage of GDP, but this is done to facilitate comparisons over time and between countries. The sustainable level of debt depends on each country's circumstances; nobody can say with precision what percentage of GDP is sustainable for any particular country. There is no identifiable tipping point. There is nothing magical about 100% of GDP. Ultimately, the bond markets decide when enough is enough and they can do so seemingly out of the blue. Crises tend to unfold rapidly and unpredictably, not gradually or in a linear fashion. The United States has more wriggle room by virtue of its reserve currency status, but ultimately that will not be enough to save it.

All we can say at this point is that US public debt has entered a danger zone; if it remains on its current path, a crisis will occur at some time, whether that is next month, next year, or next decade. There is less concern about the current level of debt than about its projected path and the failure of the political process to respond. The more it appears that politicians are failing to grapple with the problem and that the projections will become reality, the more probable a crisis becomes. That is what Standard & Poor's recent credit rating downgrade of US Treasury debt says.

Apart from the increasing risk of a sudden and debilitating crisis, a high and rising debt burden creates headwinds for economic growth by putting upward pressure on interest rates and undermining private sector confidence—the so-called 'crowding out' effects. The painstaking economic history research by Reinhart and Rogoff identifies 90% of GDP as a critical level beyond which public debt slows economic growth by an average of 1% per year, but the critical level will vary from country to country.

Another cost of a high and rising debt burden is that it narrows the government's room for manoeuvre in responding to domestic and international problems such as recessions, financial crises and wars. As interest costs absorb an increasing share of available tax dollars, government does not have much scope to do anything other than pay interest to bond holders. As the CBO said, '… the reduced financial flexibility and increased dependence on foreign investors that would accompany rising debt could weaken the United States' international leadership,' which is surely an understatement.

Size of the deleveraging task

In business language, the US government needs to deleverage. The financial crisis was a consequence of excessive financial leverage. The private sector is already deleveraging. The public sector in the United States was too highly leveraged going into the financial crisis for it to comfortably take on the additional public debt resulting from the crisis. As a result, it has entered the danger zone of indebtedness. The only question is when does it need to reduce its indebtedness and by how much. Economic growth will help but there is universal agreement that economic growth on any realistic scale will not be enough on its own to cut the debt burden. Action is needed to cut spending and/or raise taxes. Let us call this the fiscal adjustment task.

The size of the adjustment depends on the target level of debt and when the adjustment is made. The CBO calculates that to keep the debt/GDP ratio in 2035 at the same level as it was at the end of 2010 (62% for debt held by the public), an immediate fiscal adjustment of about 5% of GDP would be needed. That is, federal non-interest spending would need to be cut by 5% of GDP or federal taxes increased by 5% of GDP or some combination adding up to 5%. On a 50-year view, the immediate adjustment goes up to 6.6% of GDP.

The longer the adjustment is postponed, the bigger it becomes. Under the 2035 horizon, if action is delayed until 2015 the adjustment becomes 6% of GDP, and by 2020 it becomes 8% of GDP.

The IMF has also done these calculations but with the more ambitious target of getting the gross debt/GDP ratio (currently over 90%) back to 60% by 2030. To achieve that, an adjustment of about 7% of GDP is needed, spread up to 2020.[†]

[†] The IMF calculated the required fiscal adjustment for the United States as 11.3% of GDP, but said that about 4% will already occur under current projections to 2016, leaving a residual of about 7% of GDP.

These adjustments are large, but other countries have made fiscal adjustments of this magnitude or larger in modern history. The US deleveraging task is therefore achievable provided there is political will.

Assessing the deleveraging effort so far

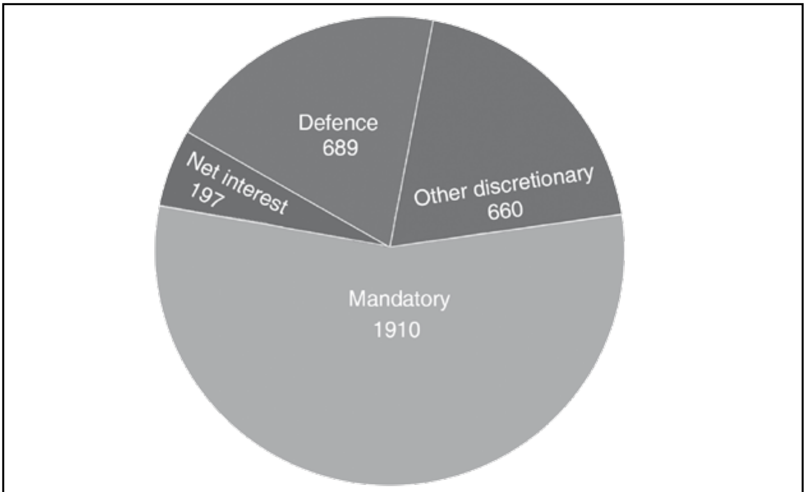
The above estimates of the size of the adjustment task were made before the recent budget cuts announced as part of the political compromise to lift the legislated debt ceiling. It is therefore instructive to compare those budget cuts with the adjustment task described above. The answer is that it represents only a small start.

The compromise involves a first instalment of $917 billion in spending cuts and creates a joint committee of Congress to come up with another $1,500 billion by 23 November. If that commission fails, or if it succeeds but the Congress fails to pass the package by 23 December, cuts of $1,200 billion will take effect automatically in 2013. Thus, the total of the first and second round cuts will be either $2,400 billion or $2,100 billion.

The numbers may sound impressive, but there is less to them than meets the eye. For one, they are sums of annual savings over 10 years, and for another, they include interest savings as well as the savings in non-interest spending. In fact, the reduction in non-interest spending in the first year is only $22 billion out of total non-interest spending of $3,400 billion. In the tenth year, the annual savings would increase to $116 billion. These amounts will expand in the second round, but by the tenth year the savings will at best be perhaps $300 billion, which by then would represent a 6% cut on that year's non-interest outlays. This would be 1.3% of GDP. Including interest savings, this becomes 1.7% of GDP. This is a start, but it's not nearly enough.

The other point about the deleveraging effort so far is that it is narrow and leaves untouched the most politically sensitive expenditure savings options as well as tax increases. US budget outlays are classified into discretionary (defence and non-defence), mandatory (dominated by three social programs, Medicare, Medicaid and Social Security), and interest (Figure 2). So far, savings have been concentrated on discretionary outlays, which comprise only 40% of the total. This approach is imposing an unsustainable squeeze on a narrow slice of the budget while leaving the social programs, which are the fastest growing components of the budget, untouched because of their political sensitivity. The social programs account for all of the projected long-term growth in non-interest outlays as a share of GDP. One test of the credibility of budget cuts still to come is that they are more broadly based and include savings in the social programs.

Figure 2: US federal government spending ($ billion)



Source: US Congressional Budget Office.

The deficit can also be cut by raising taxes (either by increasing tax rates or closing loopholes), but to date, this option has been vetoed by the Republicans. They are right to lean against tax increases, but given the magnitude of the deleveraging task, it is difficult to envisage accomplishing it without any tax increases at all.

Consequences of deleveraging for economic recovery

There is a view, widely held among commentators, that public sector austerity programs should not be attempted now because they would tip fragile economies into recession. Some in the United

States, such as Paul Krugman and Joseph Stiglitz, go even further and argue that there should be another dose of fiscal stimulus. These assertions are hotly contested by the likes of John Taylor, who sees credible deficit cuts as giving a boost to the private sector through positive confidence and expectations effect.

This is a re-run of the arguments about the effectiveness of Keynesian fiscal stimulus that raged a couple of years ago, but this time the argument is about the other side of the coin. Adherents of Keynes believe that fiscal stimulus provided a worthwhile boost to aggregate demand, activity and employment, and that fiscal retrenchment will damage demand, activity and employment, which is the last thing the US economy needs now. The opposing camp—'supply-siders' for want of a better term—do not accept these propositions. They see unsustainable debt levels as creating uncertainty and fear in the private sector that swamps any stimulatory effects of deficit spending.

My own view is closest to the supply-siders. Keynesian fiscal policy prescriptions, if they ever work, do not work in a balance sheet recession and its aftermath, which is where we are now. I accept that fiscal restraint could have short-term dampening effects on the economy, but these are a price that has to be paid for deleveraging, and they will not be fatal to economic expansion. It is difficult to imagine a more powerful antidote to the current reluctance of the US private sector to invest and add to payrolls than a credible plan of action to halt and reverse the growth of public debt over the next few years.

There are those who say the United States can have both—more fiscal stimulus in the short term and plans for deleveraging in the longer term. One finds such ideas in the editorials of *The Economist* and the speeches of the new Managing Director of the IMF. In an ideal world of lower debt burdens and fiscal managers with pristine credibility, this combination of jam today and austerity tomorrow might just work, but in the actual world US policymakers have no credibility. Any promise of fiscal stimulus today combined with restraint tomorrow would be dismissed as just another political fix to put off any action to control deficits and debt, and would provide no assurances about the future.

Conclusion

There is no public debt crisis in the United States at the moment. If there were, the Treasury would not be able to borrow for 10 years at 2%. Investors are flocking to US Treasuries, not fleeing them. There was a manufactured political crisis over the debt ceiling a month ago, which has further damaged policymakers' credibility, but that is something different from an immediate debt crisis.

Although there is no debt crisis, there is a huge budget gap that contains the seeds of a crisis. This can still be averted by strong, credible and timely policy action. The political obstacles to such action are well known, and the question is whether those obstacles will be overcome. One source of hope is that in the space of 12 months, the political consensus has gone from denial to recognition that there is a problem to action to address it, but there needs to be a lot more action.

While there is now a consensus that the deficit is the enemy, the generals are deeply divided about how to fight it. Overlaying the battle of the deficit is a battle of ideologies about the size of government, and therefore about the mix of expenditure cuts and tax increases needed to reduce the deficit. Although the deficit should be priority one, the outcome of this battle of ideologies is not a matter of indifference to Americans or the rest of the world, for it will help determine America's long-term economic future.

Do not expect any 'big bang' solutions to the deficit problem. This will be a war of attrition—a war that can still be won as long as the political system stays the course and keeps taking meaningful steps towards deleveraging over the next few years. To be credible, these steps will need to include action to curb the projected costs of social programs.

The next installment in this saga will come in November and December, and we should expect more brinkmanship in the run-up to critical dates. Something will come out of it, even if it is only the unsatisfactory fall-back option. Then the fight will be taken to next year's election, which may be the most important for a long time in setting America's fundamental direction.

Europe's Three Crises

Oliver Marc Hartwich

Almost two years ago, Robert and I predicted that the next big economic crisis would happen on both sides of the Atlantic. We are witnessing exactly that. Tonight, I am going to predict how the current European debt crisis is going to unfold.

Predictions are, of course, always difficult. The added difficulty with the European debt crisis is that it's economic *and* political. If Europe's debt problems were confined to economic issues, they would be much easier to fix.

Europe's economic issues involve a large number of discrete political actors: 27 EU member states and 17 Eurozone member states, each with its own government and parliament and some with constitutional courts. Then there is the European Parliament, the President of the European Council, the head of the Euro Group, the high representative of the European Union for foreign affairs, the European Commission, the European Central Bank, the European Financial Stability Facility, and the International Monetary Fund. And let's not forget the markets, big institutional investors, ratings agencies, banks, insurance companies, lobby groups, the media, and individual companies. That discussions about the future of the Euro are held in French, German, English, Spanish, Italian and other languages probably does not help, either.

All in all, we are looking at a system of enormous complexity in which no single institution or person is in charge of dealing with the euro crisis. This chaos, although fascinating armchair entertainment, makes it difficult to predict the future of Europe.

Nevertheless, I am going to take a stab at a plausible scenario.

The topic tonight is of course 'Trans-Atlantic Fiscal Follies: The Sequel,' but I will also have to talk about 'monetary follies.' In any case, the distinction between fiscal and monetary policy does not hold any longer in Europe now that the European Central Bank has become involved in the business of indirectly funding mainly Southern European governments through sovereign debt purchases.

Europe is not facing one crisis but at least three separate but interrelated crises. They are interrelated but not identical.

The first crisis is the most apparent: the debt crisis. Many European countries—not just Greece and Ireland but also stronger countries such as France and Germany—are heavily indebted. The official average debt of the Eurozone stands at more than 85% of GDP.* The European Stability and Growth Pact allows a maximum of 60%—a level that many economists regard as the most that a country can reasonably sustain without debt becoming a burden on growth.

The second crisis is a crisis of monetary union. The European Union consists of 27 member states, 17 of which share the euro as their common currency. Economists have long argued that such monetary unions between countries can work only in an 'optimum currency area.' Such an area is characterised by labour mobility, price and wage flexibility, the possibility of horizontal fiscal equalisation, and synchronised business cycles. The conditions in the Eurozone are far from these optimum conditions. On the contrary, Greece and Germany or France and Portugal share little else except their joint Eurozone membership. Despite this, they are operating under the same interest and exchange rates. These rates are too high for some members and too low for others, making it almost impossible to get the monetary policy just right for the whole continent. European monetary policy will always favour some countries at the expense of others.

The third crisis is of the lack of competitiveness in the European periphery. There have always been structural differences in Europe. Previously, such differences in competitiveness were reflected in long-term adjustments of exchange rates. The table shows how strong these developments were by comparing the exchange rate of the

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* http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-26042011-AP/DE/2-26042011-AP-DE.PDF

German mark to other currencies in 1963 and then, 35 years later, in 1998 at the eve of monetary union:

	France 100 FRF	Italy 1000 ITL	Spain 100 ESP	UK 1 GBP	US 1 USD
1963	81.36 DM	6.41 DM	6.65 DM	11.16 DM	3.99 DM
1998	29.82 DM	1.01 DM	1.18 DM	2.91 DM	1.76 DM
Devaluation	-63.3%	-84.2%	-82.3%	-73.9%	-55.9%

The massive devaluations of other currencies against the German mark indicate the very tight monetary policy regime of the old German Bundesbank and the high competitiveness and productivity of the German economy compared to the rest of Europe.

European economies like Italy and Spain but also France had to continually devalue their currencies to remain competitive with Germany. Once the monetary union was introduced, such devaluations were no longer possible. Germany's neighbours had to make themselves more competitive by reforming their product and labour markets, deregulating their economies, and improving their whole system of governance. Sadly, this never happened.

In addition to the three simultaneous crises of debt, monetary disparities, and competitiveness, there is a fourth crisis waiting to happen. Europe's banks are undercapitalised, and in their current state they would not be able to absorb a sovereign default. The last round of the EU banking stress test, tellingly enough, did not even attempt to model such an event.

The economic problems for European policymakers are compounded by the added complication of the political desire to persevere with the project of monetary union at all cost. If countries like Greece left the Eurozone, it would bankrupt many of the banks who have lent money to Greece. At least that's what France fears.

Germany fears something completely different—that a departure of weaker Eurozone members would lead to a massive appreciation of the euro and undermine the competitiveness of German exports. With exports accounting for almost 50% of Germany's GDP, the Germans rightly fear losing the competitive advantage of their subdued exchange rate.

At the same time, neither France nor Germany has an interest in permanently paying for weaker Eurozone countries. The French can't afford it *and* keep their AAA rating; the Germans don't want to be punished for their economic strength.

An analysis of the specific national interests of all Eurozone member states shows how different they are.

The Italians and the Spanish are demanding the introduction of eurobonds—jointly guaranteed government bonds—so they can pay lower interest on their own government debt. The Germans and the Dutch are rejecting this because it would increase their borrowing costs.

Here's another example: inflation rates are moving in different directions in the Eurozone. In the second quarter of 2011, inflation went up in Germany, Belgium, Estonia, the Netherlands, Austria and Finland but fell in other Eurozone economies.[†] Consequently, there are calls for monetary tightening in some countries while others need to avoid it at all cost.

The Eurozone crisis is so messy because the interests of the different players are not only discrete but completely incompatible. Worse, there is no one solution that would work for everybody.

This is the main reason why for the past one and a half years, EU policymakers have only been buying time while glossing over the most acute problems of the Eurozone. First, they gave financial assistance to Greece so that its crisis would not spread to other countries. Then the European Central Bank tried to drive down yields on euro periphery bonds by purchasing them on the secondary market.

This strategy failed for Ireland and Portugal. Both had to seek refuge under the umbrella of the European Financial Stability Facility. However, that did not calm bondholders' nerves for too long, and eventually the European Central Bank extended its bond purchases to Spain and Italy.

[†] www.boerse-go.de/nachricht/EWU-Inflation-sinkt-auf-25,a2620090,b199.html

There is a pattern in these policies. European governments and the European Central Bank get involved only when it becomes absolutely unavoidable to avoid imminent disaster. And even then, they only do what is needed to calm the crisis for a few weeks without ever addressing the underlying fundamental problems: debt, monetary union, and the competitiveness divergence.

The question now is for how long can this game continue. Can Europe just keep kicking the can down the road? Is there a limit to buying time? Will it eventually find a real, lasting solution to its three crises?

The answer to these questions is simple. Yes, Europe has been kicking the can down the road. But it has reached the crossroads where markets are forcing it to decide between abandoning the project of monetary union in its current form or moving towards a full fiscal and political union.

Faced with this choice, I am convinced that they will give up monetary union. I don't believe the euro will survive another year in its current form, mainly because of the diverging interests described earlier.

Markets are nervous about the ability of some European governments to service, let alone repay, their debt. In my mind, rightly so.

Greece is by any account bankrupt. Its debt to GDP ratio is so high that it will never be able to restore it to a sustainable level. The Greek economy is shrinking; unemployment is rising; and bar a 20% internal devaluation, the country will not be able to compete with its European neighbours. A Greek default is inevitable.

Ireland has made progress but is still unable to finance itself in international markets at reasonable interest rates. The situation is even worse for Portugal, which has not seen any productivity growth for more than a decade.

These small countries could, of course, be kept alive by other Eurozone countries. But the crisis has now spread to the heavyweights of Italy and Spain. The European Central Bank has been purchasing Spanish and Italian bonds to drive down yields. This has had the desired effect but at great cost. And despite this, yields are rising again because markets sense that the European Central Bank is bluffing.

In order to permanently save Italy and Spain, a massive extension of the bond buying activities would be necessary. However, this 'nuclear' option by which the European Central Bank intervenes to the tune of a few trillion euros would not only be monetary madness—it would be politically impossible to communicate this to the stability concerned Germans, Dutch and Austrians.

So what will happen once Italian and Spanish yields reach danger levels yet again?

I think there will come a point when the Germans will cut the cord. They will not allow their currency to be destroyed by continued quantitative easing (because that's what it is), nor will they be willing to give in to a transfer union and eurobonds. This leaves only one way out: pulling the plug on monetary union. Besides, the political differences in Europe are so enormous that there can be no consensus for the alternative—a fiscal and political union.

It is difficult to forecast what will happen once the Germans pull out of the union, but it is plausible, perhaps even probable, that they will establish a new bloc of countries that share their commitment to monetary stability and greater fiscal discipline. This could be the new North Euro, consisting of countries like the Netherlands, Austria, Finland, Luxembourg, Estonia and Slovakia.

This solution would be painful to German manufacturers: it would require a recapitalisation of some banks holding Southern European bonds and may lead to greater tensions within the European Union.

On the positive side, this is the only solution that avoids the creation of a giant redistribution mechanism in Europe. It makes it possible for countries like Greece to regain competitiveness through default and devaluation, and it would be a way for Europe to dig itself out of its current mess.

This is the only plausible way for Europe to deal with the debt, monetary union and competitiveness differentials. It's a shame policymakers are going to exhaust all possible alternatives before taking this only workable solution to their three crises.

Saving Our Way to Security

Adam Creighton

Donald Horne's 1964 description of Australia as the 'lucky country' remains apt. Australia sailed through the Asian Financial Crisis in 1998, and the economy barely faltered during the global recession of the early 2000s.

The good story continues. Australia's growing links with Asia insulated us from the worst of the financial crisis of 2008. Now an unprecedented resources boom bolsters our incomes and confidence.

Nevertheless, economies in Europe and America are increasingly strained, as demographic change and long-standing fiscal irresponsibility take their toll.

Australians should be concerned but we remain in rude health by comparison. Our unemployment rate is much lower; our governments—both state and federal—are not burdened with daunting debts; the Australian dollar is strong; price inflation is relatively low; and our positive real interest rates discourage excessive borrowing.

And so the good story should continue … more or less.

Economic problems in Europe and America matter relatively less for Australia than they did, say 20 years ago. Australia's trade and economic future is increasingly tied with Asia.

It's no secret that China is our biggest trading partner, having overtaken Japan in 2009. It's probably less well known that eight of Australia's top 10 export destinations are in Asia. The United Kingdom and United States round out the list.

Our dependence on Asia will only increase. For example, Australia recently signed a free-trade agreement with ASEAN countries. These countries, of which Indonesia is by far the largest, have a population of 600 million, or about 100 million more than the European Union.

The ASEAN countries' economic growth is twice that of Europe, and their population is growing 14 times faster than in Europe (Europe's population growth rate is close to zero).

The Asian connection is more than trade in goods and services. Excess Asian savings are increasingly available to finance Australia's traditionally large current account deficit. More and more Asian governments, firms and individuals will supply capital, directly or indirectly, to Australian businesses.

Australians themselves are also modifying their behaviour in a way that makes us more resilient to economic shocks in Europe and America. For example, we are saving more. Australia's savings rate has surged to 10%, up from -2% in the mid-2000s.

The savings rate had been in secular decline throughout the 1980s and 1990s as the financial system was deregulated and interest rates fell, making credit easier to obtain.

It's not just the level of saving but where it is going. We are now more likely to save in safer assets like bank deposits rather than shares and housing. The housing and the share markets are lacklustre at best, while the proportion of the major banks' balance sheets financed by Australian deposits has risen to almost 50%.

Far from being the calamity Keynesian economists (and retailers) make extra saving out to be, Australians are in a far better long-run position for it. Ever greater debt-fuelled expenditure on consumption items is not a panacea. Higher personal saving rates mean Australians can better absorb periods of unemployment and maintain their expenditure during downturns.

But another economic 'crisis' overseas is possible and perhaps even likely, as large developed countries try to pay back or even evade their crippling debt burdens. Banks and investors could make large losses.

The fallout could be felt in various ways in Australia: a precipitous fall in demand for our exports; a collapse of the Australian dollar; or an increase in the cost of credit on international financial markets, which could in turn push up domestic interest rates—not to mention propagation of general fear that drives our investment decisions.

We cannot fully insulate ourselves from these impacts; indeed, they are a natural part of globalisation, but we can prepare ourselves to better withstand them.

Donald Horne's full remark about the 'lucky country' is the following: 'Australia is a lucky country run mainly by second rate people who share its luck.'

Although I don't agree we are run by second-rate people, either now or in 1964, our public spending is second rate. This is where we can best change behaviour to reduce any fallout from overseas developments.

The good news is the federal government has a fiscal strategy. The May 2008 budget boasted:

> This Budget ushers in **a new era of economic responsibility**, delivering a strong budget surplus and reprioritising spending to sustain growth in the long term, to ensure that fiscal policy plays its part in putting downward pressure on inflation and to ensure a strong economy at a time of international economic uncertainty. [emphasis added]

The new era had three key prongs:

1) to run budget surpluses, on average, over the medium term
2) to keep taxation as a share of GDP below the level of 2007–08, and
3) to hold real growth in spending to 2% per year until the budget returns to surplus.

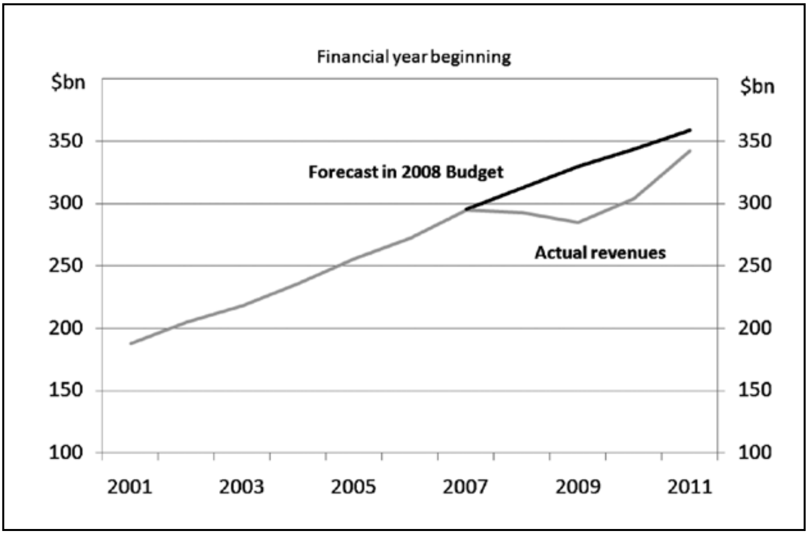
These undertakings are somewhat rubbery.

Take the first goal. Since coming to office, the federal Labor government has introduced four budgets and each has resulted in a massive deficit. The 2009 deficit was the biggest as a proportion of the economy since 1945—4.3% of GDP (or $55 billion). That was followed in 2010 by the biggest deficit since 1993—$49 billion (or 3.6% of GDP).

Note that that latter budget deficit would, were Australia part of Europe, break the European Growth and Stability Pact.

To be fair to the government, it is important to recognise that government revenues slowed significantly from 2008 (Figure 1). They even fell a little in 2009, which made it difficult for the government to meet its surplus target.

Figure 1: Commonwealth government revenues



Source: Commonwealth Budget 2011–12.

But the government's massive 'stimulus' package was the biggest surge in spending since the Whitlam government. It made the deficits vastly worse.

This financial year another sizeable deficit is expected, and next year an increasingly unlikely tiny surplus of $3.5 billion, which is less than 1% of government revenue.

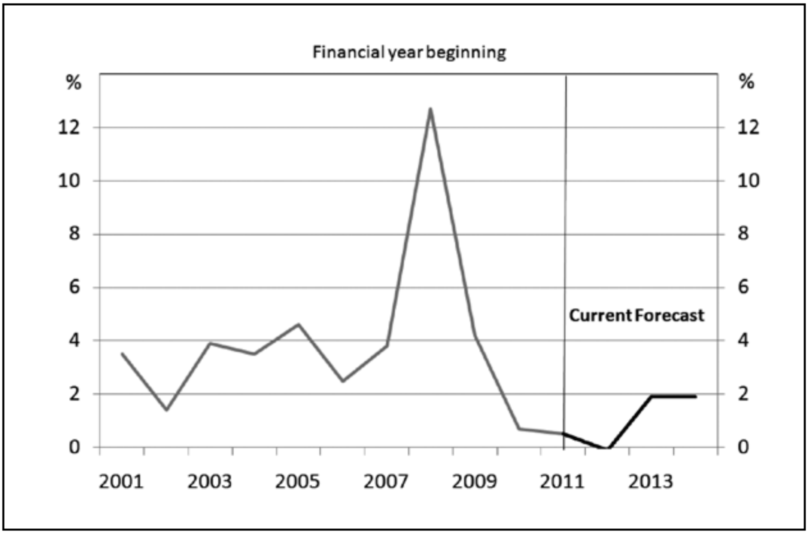
The government will say that its promise was to have surpluses 'over the cycle.' First, this is a meaningless concept in practice, and second, Australia has not even experienced a recession.

The government's second aim to keep taxation below 23.5% of GDP (at 2007–08 levels) appears commendable, but it is a sleight of hand. The real metric should be what is happening with spending as a fraction of GDP. Spending must ultimately be paid for with taxation.

Unfortunately, spending in Australia has been more than 25% of GDP since 2008. It is set to decline in the future, but only if the government's projections are realised.

That leaves the third aim: to keep real spending growth below 2%. Normally, this would be a relatively impressive achievement. Annual real spending growth under the Howard government, for instance, was greater than 2% in eight out of 11 years, sometimes closer to 4% (Figure 2).

Figure 2: Commonwealth annual real increase in spending



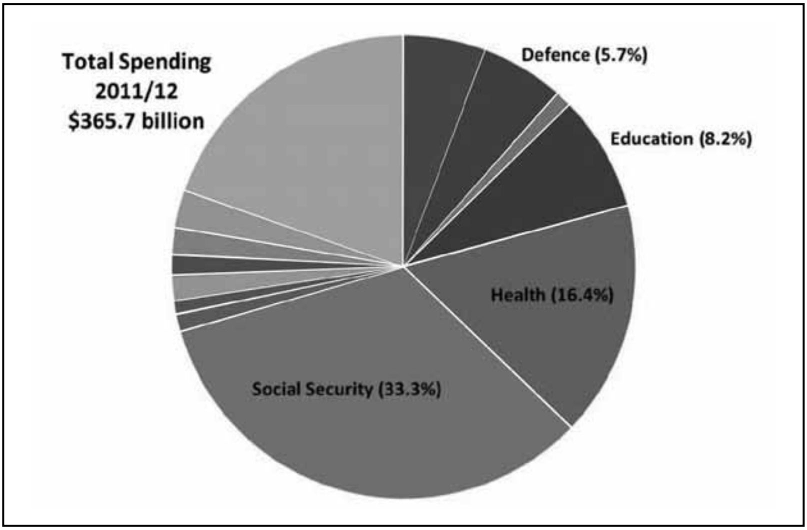
Source: Commonwealth Budget 2011–12.

But to repeat the 2% aim now, after such a massive real increase in government spending (12.7% in 2008–09 and another 4.2% in 2009–10), is not appropriate. A target of 1% real growth in spending would be better.

Rather than talk in the abstract, let's talk about some savings.

Figure 3 shows the current distribution of federal government spending.

Figure 3: Total spending in 2011–12



Source: Commonwealth Budget 2011–12.

The Opposition has been under pressure recently to come up with $70 billion of savings. Apparently, this is the figure required to pay for the Coalition's own promises, improve the budget bottom line, and rescind any mining tax.

The government doubts the Opposition can come up with such a figure. One prominent commentator dubbed the amount 'unfindable.'

On the contrary, it is certainly findable. For one thing, the $70 billion is spread over four years or about $17 billion a year, which is less than 5% of annual Commonwealth spending!

It is possible to make cuts of that magnitude without taking a cent from core, long-established federal government programs like the Age Pension, Newstart, Disability Support Pension, Pharmaceutical Benefits Scheme, Medicare, or funding to the states (Figure 4).

I chose savings from health and welfare, because they are the two fastest growing areas of expenditure over the next four years. And I selected industry subsidies because of the intrinsic damage they cause to the economy.

Figure 4: Savings

		2011	2012	2013	2014
First Home Owners Grant*		1,000	1,020	1,040	1,061
FaHCSIA	FTB B (1.2)	4,429	4,559	4,699	4,830
	Supporting Families with Teenagers	276	723	899	921
	Baby Bonus (1.3)	916	936	963	997
	Paid Parental Leave (1.3)	1,345	1,439	1,535	1,593
	Gender Equality for Women (6)	50	43	48	44
		7,016	7,701	8,144	8,385
ATO/Treasury	Fuel Tax Credits (1.12)	5,142	5,614	5,715	5,819
	Education Tax Refund (1.13)	888	915	934	956
		6,030	6,529	6,649	6,775
Health	Prevention, Early Detection, Service Improvement (1.1)	123	114	119	104
	Drug Strategy (1.3)	243	245	248	240
	Public Health (1.6)	57	51	56	56
	Primary care practice incentives (5.3)	315	297	254	258
	Workforce development and innovation (12.2)	351	295	276	279
	Health Information (10.3)	35	35	32	33
	International policy engagement (10.4)	15	15	15	15
		1,139	1,052	1,000	985
Industry Subsidies	Productivity Commission listed subsidies	3,700	3,774	3,849	3,926
		3,700	3,774	3,849	3,926
Grand Total		**18,885**	**20,076**	**20,683**	**21,133**

Source: Commonwealth Budget 2011–12; author's calculations.
* Strictly, a state government expenditure.

The first home owners grant pushes up house prices and transfers wealth from poorer Australians to richer ones—this policy was introduced 10 years ago at the behest of the Commonwealth government (although it is now financed by the states) and could be abolished at the Commonwealth's insistence.

The Fuel Tax Credits Scheme is a refund of petrol tax to businesses that operate big trucks. It is better to treat all businesses equally and allow them to pass on the costs of fuel if they so choose.

Moreover, it is contradictory to encourage fuel consumption (as this policy does) and impose a carbon tax at the same time. It would be far better to remove costly hidden subsidies to fuel consumption and not impose the carbon tax.

The Family Tax Benefit B, the Baby Bonus, and Paid Parenting Leave are not necessary when Family Tax Benefit A exists, which is a means-tested payment to mothers per child regardless of whether they are in work or not.

The education tax refund is blatant middle-class welfare, allowing tax deductions for personal computers, shoes and stationery.

The health programs listed above are examples of nanny-state 'raise awareness' coddling. There is no real evidence to back their effectiveness. The other schemes are direct payments to medical professionals for doing their job. I personally doubt they are even constitutional.

The Productivity Commission estimates that the federal government provides more than $8 billion a year in industry subsidies, of which $3.7 billion is direct payments from government to business and the remainder is tax concessions. Industry support has actually increased by 21% since 2003.

Moreover, 46% of assistance goes to services (which aren't tradeable) and 27% goes to primary industries and mining—industries experiencing a major economic boom!

Winding down this assistance, at least the direct outlays, would improve Australia's economic performance after an initial painful adjustment.

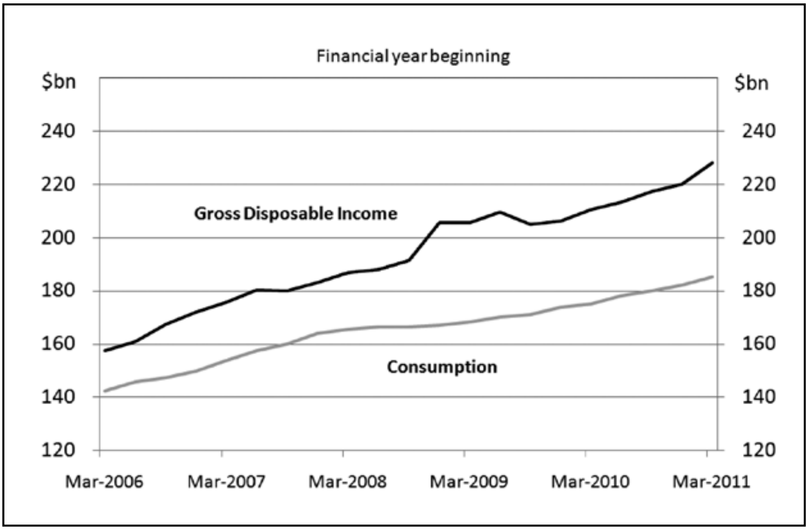
If all these savings were returned to taxpayers uniformly, every worker could be about $40 better off each week. And that's only the initial effect. Such a move would foster a more efficient, productive, and crucially in this context, more *resilient* economy. It would also be a boon for consumption spending and saving.

But don't expect such cuts to materialise, however reasonable they might be. Vested interests and political timidity are too overwhelming. In fact, I fear the opposite is more likely—another stimulus package.

This would be very disappointing, as the first package was damaging and wasteful—and based on an ideology that evidence and logic have routinely refuted.

Two graphs help make this point.

Figure 5: Stimulus and household behaviour

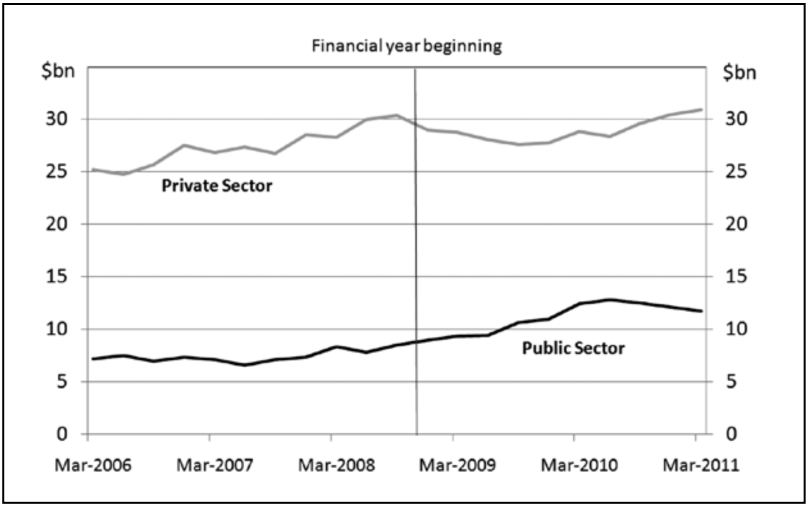


Source: Australian Bureau of Statistics.

Figure 5 shows Australians' gross disposable income and consumption expenditure. Sure enough, during the GFC disposable income leapt as the Rudd government showered the population with borrowed money. But consumption did not increase.

Figure 6 shows the value of public and private construction in Australia over the same period. The vaunted Building the Education Revolution was a multi-billion-dollar program to build school halls.

Figure 6: Value of construction



Source: Australian Bureau of Statistics.

The private sector appears to have been crowded out. The value of public work rose as the value of private sector dipped. Now that the BER has ended, private sector construction is increasing.

Australia sailed through the Asian Financial Crisis and the global downturn of the early 2000s without any stimulus package. We relied on our flexible exchange rate and independent monetary policy. We came out of those episodes without a massive increase in government debt.

So, absent making sensible spending and tax cuts, the best we can hope from our political leaders is that they do nothing.

Finally, many say that we don't have much debt, that we have 'plenty of room' to stimulate the economy, so we should at least try.

It is true that our net debt to GDP ratio in Australia is about 7%, which is orders of magnitude lower than those in the United Kingdom (about 80%) and the United States (about 70%).

But such statements about 'low debt' must be qualified.

First, they are cast in terms of fractions of GDP, not as a fraction of the size of the relevant government. In Australia we have a smaller government sector, at least compared to European countries. So the burden of servicing the debt is greater for our government sector.

Second, Australia pays higher interest on its debt than larger nations, sometimes twice as much. The Australian government can borrow for 10 years at about 4.5% interest. The US and the UK governments, for example, can borrow closer to 2%.

By way of example, interest payments absorb about 3% of Australia's revenue, and about 12% of America's, despite America's debt to GDP ratio being about 10 times Australia's.

So Australia's headline figure of 7% is not as benign as it might first appear. To shock proof the economy, it is best, especially for a medium-sized economy like Australia, to keep its public debt burden low.

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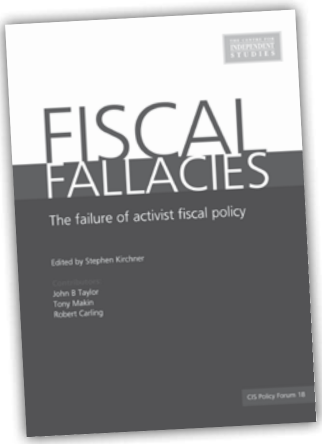

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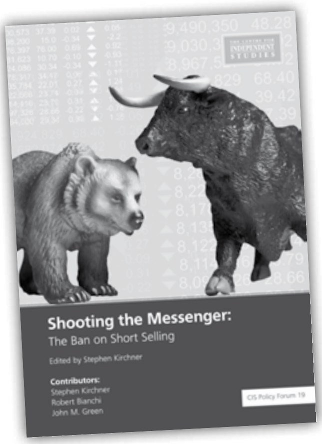

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Robert Carling is a Senior Fellow at The Centre for Independent Studies. He was Executive Director, Economic and Fiscal at the NSW Treasury from 1998 to 2006. He was a senior official with the NSW Treasury until 2006 and prior to that with the Commonwealth Treasury, the World Bank, and the International Monetary Fund. He holds academic qualifications in economics and finance from the London School of Economics and Political Science, Georgetown University, and the University of Queensland.

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