

Investment update

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Obamas stance against austerity

About 10 days before the G20 summit in Toronto in late June, US President Barack Obama wrote to the other leaders attending the world's most crucial summit to warn against the trend for advanced economies to cut fiscal stimulus.

What Obama is worried about is that European countries are reining in government deficits when their economies are fragile. Their actions threaten to derail the global economic recovery and herald Japanese-style stagnation for the world.

No doubt Obama would know that European countries are repeating the mistakes policy makers made in the US in 1937. This was the year Franklin Roosevelt prolonged the Great Depression by cutting economic stimulus.

The troubled eurozone economies of Greece, Ireland, Spain and Portugal are attacking fiscal deficits because they want to break the cycle of how large fiscal deficits prompt rating downgrades that make borrowing more expensive. The steeper borrowing costs then widen government deficits and trigger another downgrade.

Obama's concern is more that creditworthy European nations such as France, Germany and the UK are taking to austerity. Even stop-start Japan is considering reducing stimulus by capping spending, even though policy-makers there in 1997 triggered a 20-month recession when they cut economic support by raising sales taxes.

The worry is that spending cuts and tax increases reduce the demand that drives economies and government finances come under fiscal pressure anyway because non-discretionary spending – unemployment benefits to more people, for instance – rises while tax receipts fall as economic growth slows.

Few dispute that government deficits need to be reined in over the medium term. But the pro-stimulus camp that Obama belongs to argue that this should occur only when economic growth is sustainable enough for spending cuts – rather than interest rates rises – to be used as a policy tool to ensure inflation stays tame.

Obama's letter failed to sway his G20 colleagues. They duly decided to aim to halve their budget deficits by 2013. It remains to be seen what the result will be for the world and Australian economies.

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