SPECIAL FX

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Gas Now, Brake Later

The G20 finance ministers and central bankers are meeting in South Korea to prepare for the summit in Toronto in a few weeks time. There seem to be three broad areas of discussion. The first is the European debt crisis, which causing some disruptions and strains in the global capital markets and could put at risk the fragile economic recovery. The second is balancing the economic risks with the need for fiscal consolidation and coordination the re-regulation of the financial sector. The third is the old nemesis of global imbalance and here China may be *encouraged* to allow the yuan to appreciate.

Mars and Venus

Around the US decision to invade Iraq, a neo-conservative thinker suggested that it was as if the America was from Mars and Europe was Venus, with all the martial implications. This was obviously overly simplistic and meant to be provocative. Yet, it is becoming increasingly clear that there is a wide discrepancy in terms of economic policy on normative (what ought to be the case) and descriptive (what is the case) grounds. Moreover, this difference is a significant obstacle to substantial agreement.

The April G20 meeting was a grand compromise. The final statement urged countries to balance the unwinding of the fiscal and monetary policies enacted during the worst crisis since the Great Depression with the need to ensure that the economic recovery is taking hold. It called for credible exit strategies, but urged countries that could, to wait to exit until the recovery was more entrenched.

Something has happened between that G20 meeting and this one. Some pundits would have us believe that the US subprime problem morphed into the European sovereign debt crisis. Don't buy it. Once again, they have confused correlation with causation. They are both related to a third force: a gross mispricing of risk and incredible leverage achieved by a combination of financial technology and gaming regulatory regimes.

While US banks lent to sub-prime households, European banks not only bought derivatives based on those loans, but they made their own loans to sub-prime countries in their neighborhood. Isn't that what is implied by the market's resuscitation of the old derogatory "PIGS" acronym?

US banks did not appear to make many of those loans on a rational assessment of the ability of the household to service the debt. Instead, those loans were made on the basis of the anticipated value of the collateral. That seems why there was a sub-prime real estate problem but not a sub-prime auto loan problem.

European banks made the loans to the Mediterranean sovereigns seemingly because they thought that defaulting was something developing countries do; not advanced industrialized countries, and surely not members of the highly exclusive EMU club. Maybe there was an element of moral hazard as well, suspicion that the EC and/or the ECB would prevent a default. Perhaps naiveté played a role too. European banks wanted to believe that the euro was as good as the steel of the old uber-mark even though it had been mixed with weaker alloys.

Gas or Brake?

This G20 meeting will find it more difficult to paper over the differences between the US and Europe. The policy response to the sovereign debt crisis has been to reduce European budget deficits. This entails a combination which varies from country-to-country of spending cuts and tax increases. In contrast, a new stimulus bills is making its way through the legislative process.

The Obama Administration's leading economic officials—Tim Geithner, Christina Romer and Paul Volcker were in Europe in late May and essentially cautioned their hosts against cutting spending too quickly. They urged Europe to focus on growth rather than cutting spending.

That is what the US is doing. It is betting, as it were, that stimulus will foster faster growth and this will ultimately produce higher tax revenues that can be used to pay down the debt. The US is choosing to accept wider deficits now to avoid a double dip in the economy, which would produce even larger deficits.

Indeed the growth that appears to be boosting tax revenues and allowing the Treasury Dept to reduce the size of the bond auctions. Corporate profits in Q1, for example, were around 12% more than expected, according to some industry surveys. The OECD's latest estimate is for the US to grow 3.2% this year. That is up more than 0.5% from its forecast at the end of last year. It also warned that it was not clear if the "output growth is yet at a self-sustaining and how the economy will responds as the effect of the stimulus ebbs."

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Some critics say that the US economy would have grown without the stimulus and the vast sums have been squandered. It is always difficult to refute counter-factual claims. The fact of the matter is that various time series, including consumption, auto sales and housing activity, clearly show the impact of government stimulus.

What of the huge debt the US has taken on? The idea that it will be passed on to the next generation is simply and utterly wrong. Necessity requires that it is addressed in the next few years. The US Treasury announced on June 2nd that the US debt had reached $13 trillion. It grew $1.6 trillion last year alone and has doubled in the past decade. It stands near 90% of GDP.

The IMF projects that, assuming no action, in 2015 the US structural deficit (which is what it would be if there was full employment) would be 6% of GDP (4% in the euro zone by comparison). The problem is well beyond simply discretionary spending. The mandatory spending—Medicare, Medicaid, Social Security and debt servicing will be approaching the 16-18% of GDP, while the most the federal government has been able to raise in taxes is about 21% of GDP, in 1999 at the height of the internet and stock option bubble.

It is Political Economy

As the US economy strengthens, tax revenues increase and counter-cyclical spending will decline. The decline in the cyclical deficit will make it politically more palatable to address the structural deficit and it still won't be easy. Politics is an important consideration, whether we want it to be or not.

Given the still high unemployment rates, including discouraged workers and those working part-time but want full-time employment, it not only makes good economics but good politics too not to stress the necessary austerity until after the November elections.

The Obama Administration needs to avoid giving its opposition potentially important campaign issues and therefore has to triangulate between promoting growth strong enough to bring down the unemployment rate and to demonstrate some progress and commitment to reducing the budget deficit.

By the end of the year, there is good reason to expect the US to begin demonstrating its resolve to address its fiscal challenges. Shortly after the November congressional election, in which the party that occupies the White House typically loses seats in both houses (and this time does not look different), the National Commission on Fiscal Responsibility (did you roll your eyes?) will unveil their recommendations for addressing the US structural deficit. This blue-ribbon committee is composed of 18 members—six Democrats, six Republicans, four from business and two chairmen.

There are two reasons why this is not your typical kick the can down the road course. First, the recommendations require the support of 14 people on the committee. That means there must be some bipartisanship. Second, the leaders of both houses (the Democrat majorities are likely to be retained) have promised an up-or-down vote on the recommendations.

It is Our Nature

The institutional and political constellation in Europe generates typically generates slow growth. Over the past five years it has averaged about 0.75% a year and the five years before that it averaged 1.25% a year. The contrasting US figures are 1.2% and 2.6%. The US and Europe are pursuing policies that will reinforce this pattern.

To be sure, deficits do matter (apologies to Cheney) and the US can no longer grow its ways out of its deficit, the way it did under Clinton. But, the superior growth and be favorable demographics will make it less difficult to address than the opposite, as Europe will experience.

Aesop told a fable about a scorpion who happens by a frog near a river. The scorpion asks the frog to carry him across the lake. The frog is cautious. "You'll sting me and we will die," he said. The scorpion promised not to and the frog agreed. They are in the middle of the river and the scorpion stings the frog. As the frog and scorpion were drowning, the frog cried, "Why did you do that? The scorpion replied, "It's my nature."

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