

Special Report: Austerity vs. Expansion: On The Brink Of Global Depression

Contributed by Euromonitor International

Since the 2007-2008 financial crisis there have been two major shifts in economic policy in the developed world.

The different policies have had contrary effects on rescuing these countries from stagnation.

Austerity in Western Europe is doing little to support the increasingly unstable environment, while expansionary fiscal policy has had more success in the developed economies of Asia Pacific. As Europe's debt crisis lurches on, a more balanced approach to spending and austerity is growing.

Source: Euromonitor International from International Monetary Fund (IMF), Government Finance Statistics (GFS)/national statistics/Eurostat

Note: Figures for 2012 are forecasts

Key Points

- In 2008, as the financial crisis reverberated across the financial markets there was a concerted effort by the developed world to increase government spending to support economic growth. Government expenditure in the 34 developed economies increased in real terms by US\$1.2 trillion between 2008 and 2010;

- However after 2009 the policy response to low growth changed. Western Europe embraced the doctrine of fiscal rectitude. Governments pushed to get their "houses in order" by rapidly balancing budgets and paying down public debt in an attempt to engender investor confidence. This resulted in welfare cuts, fewer government services, and increases in tax;

- Asia Pacific and Australasia however continued on a path of government spending. On average government spending increased in real terms by 8.4% between 2008 and 2011 in the developed Asia Pacific countries and Australasia. This expansion coincided with an increase in average real GDP of 8.1% in the same countries over the same period, though positive regional demand from emerging markets supported these economies significantly;

- The eurozone fully embraced austerity largely due to restrictions in policy choices thanks to the currency union. Average annual real GDP growth shrank by 0.4% in the eurozone between 2008 and 2012 and output in the eurozone is expected to contract by 0.6% in real terms in 2012. Multiple factors have contributed to the region's weak growth however persistent austerity measures are a major factor;

- The eurozone remains embroiled in crisis and other European economies, including the UK are struggling to find growth. As a result economic policy is shifting once again, with growing support for expansionary policy. Ongoing discussion in France, Britain and even Germany has led to these countries looking for areas to increase spending in an attempt to stave off even deeper recession in the remainder of 2012 and into 2013.

Expansionary Austerity

In 2010 a new economic theory found its voice, which has led to governments focusing on reducing their budget deficits, demonstrating long term fiscal responsibility in an attempt to attract business investment and reduce government borrowing costs. "Expansionary austerity" was extolled by the naturally austere Germans, but also became a pledge for the Conservative government in the UK.

- As this economic theory gained traction and the eurozone crisis worsened, austerity was implemented across Western Europe in 2010. Two years on, the results of the austerity mantra are not encouraging. Although more fundamental imbalances in the eurozone have subdued growth there is little proof of the policy benefitting any country that embraced it. The UK is a natural experiment for the policy, the government's fiscal position is comparatively benign to many of its eurozone neighbours thanks to very low borrowing costs, while there was and remains little fear of capital flight;

- Between Q4 2011 and Q2 2012 the UK has suffered from an increasingly deep recession, its second in less than four years. Most importantly however gross fixed capital formation (GFCF), a measure of total investment, including business investment in the UK has declined in real terms between 2010 and 2012 by 10.1%, a period where, according to austerity theory, investment should have grown. On top of this the relatively high unemployment rate of 8.1% has not declined in any significant manner in 2012. The IMF has estimated the austerity measures have cut the country's gross income by 2.5% between 2010 and 2012, while little confidence has been nurtured in the economy;

- In the countries enacting austerity, increases in GFCF have not occurred. Ireland for example, has undergone

significant austerity after a major government funded bailout of its financial sector. However GFCF is estimated to have declined by 67.2% in real terms between 2008 and 2012. Even after the country's output reached the bottom of its precipitous decline in 2010 GFCF has not recovered.

Expansionary Expansion

Outside of Western Europe the approach to the recovery has generally differed. In theory, greater government spending on infrastructure and national services increases employment and supports industrial output. This in turn increases spending in the consumer markets by the newly employed, supports confidence and creates a cycle of increasing demand, supporting growth in the economy.

- Evidence so far from the developed economies of the Asia Pacific points towards a supportive effect of expansionary fiscal policy. It is important to note demand from Asia's emerging markets has been a major boon for growth in Japan, South Korea, Taiwan, Singapore and Hong Kong. Regardless, accommodative fiscal policy has supported strong economic growth, real GDP grew by 8.1% between 2008 and 2011 in the developed economies of Asia Pacific and Australasia. The recovery in output in turn buoyed recoveries in business confidence and consumer spending;

- South Korea is an example of a country that grew relatively well during the financial crisis largely due to expansionary government policy and strong external demand. Between 2008 and 2011 government spending increased in the country, in real terms by 5.9%, this has supported an expected increase in real GDP of 10.5% over the same period.

The Shifting Consensus; a New Compromise

After almost three years, support for austerity measures in Europe is declining. The successful presidential election campaign of Francois Hollande in France, the rise of Syriza in Greece and mass protests in Italy and Spain have all been driven by pro-growth rhetoric. Even the staunch austerity position of the British coalition is softening. There have been two important moves in 2012 that signify economic policy is coming full circle, with expansionary policy once again being emphasised in discourse.

- In June 2012 Francois Hollande, the French president proposed a eurozone "Growth Pact", creating at least €120 billion worth of spending for 2012 and 2013 aimed at increasing employment and output in the region. Though the pact was not ratified in June's EU summit this is an important move in Europe's policy debate;

- In its July 2012 "Economic Health Check" the IMF announced the need for sweeping reforms to safeguard the eurozone project, as well as supporting the new "Growth Pact". On top of this the IMF has come out in favour of increased spending measures in the UK, including increased government spending on infrastructure. This turnaround is of particular importance as the IMF was a staunch supporter of austerity policies in 2009;

- Current evidence suggests a relative failure of austerity policy on its own. A continuation of these policies is not expected to engender support or a dramatic economic recovery in the future in any of the countries enacting it. The impact on consumer and investor confidence is therefore increasingly negative as long term growth prospects remain poor. This is resulting in a move towards a pro-spending position in the UK and Western Europe in an attempt to kick start economic growth once again. However given the high levels of public debt in Europe, any increases in spending will be smaller than the stimulus packages of 2009.

Prospects

The growth prospects of the developed world have heavily diverged since the crisis of 2008. Without major U-turns in economic policy in Western Europe this divergence is expected to continue in 2012 and beyond.

- The economic prospects of the eurozone for the rest of 2012 and into 2013 in particular are poor. Average real GDP growth in 2012 of 2.6% is forecast in the developed economies of the Asia Pacific while Western Europe is facing a contraction of 0.1%;

- The European Central Bank has enforced austerity programmes in Greece, Spain, Italy, Portugal and Ireland, which is exacerbating their economic downturns. Danger of government insolvency has meant these countries now have no choice but to force through further austerity measures. This self-reinforcing cycle of austerity, depression, insolvency risk and further austerity is worsening in 2012;

- Inaction by governments in fostering economic growth is having long term effects on the labour markets of their economies. Since the 2007-2008 financial crisis unemployment has remained at elevated rates across Europe; in July 2012 UK unemployment was at 8.1%, of the economically active population in Spain it was 24.8% and in France unemployment reached 10.3%. Spells of unemployment reduce the skills workers have and as a result, some of the labour force is becoming deskilled creating a long term reduction in the potential output of an economy. This is occurring across Western Europe and provides considerable risk for the region's longer term growth prospects;

- As the developed western regions continue to flounder in low or negative growth rates the impact on emerging markets

is increasing. China is succumbing to weakened demand in its external markets; as a result the country is inching closer towards a hard landing as the weak external sector transmits a slowdown into the domestic markets. Declines in oil prices have affected Russian economic growth while Brazil's economy is expected to cool in 2012 thanks to slowing industrial activity. The impact of economic policy in the west is no longer isolated to the developed world but is in danger of creating another global economic slowdown.

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