Europe may have got it right at the G-20

By JOERGEN OERSTROEM MOELLER

The Group of 20 (G-20) meeting which ended over the weekend in Toronto did not go much to advance the agenda for the global economy despite the obvious need for action. The main reason is that the two players most in need of economic recovery (the US and Europe) take a diametrically opposite view of what needs to be done.

Phase One of the global recession is now coming to an end. It was dominated by a scramble to stimulate the economy primarily by running up already excessive public deficits, hoping this would do the trick as it did in the early 1990s during the Great Depression. The economy, however, had not read the script. Current figures reveal that the recovery is neither strong nor sustainable. In fact, figures for US growth in first quarter 2010 were revised downwards a few days ago from 3.2 per cent to 2.7 per cent.

While this stimulatory policy garnered near unanimity among major economic powers - albeit with differences about its size - Phase Two of the crisis divides countries into two groups.

Most of the European countries are opting for cutting expenditures and raising taxes, seeking re-establishment of "sound" public finances (lower deficits, lower debts). Public consumption will be hit hard, under normal circumstances, that will kill the fragile recovery. The Europeans are fully aware of that, of course. Their thinking runs somewhat deeper, though. The target is to restore confidence, the loss of which threatens prospects for the economy in the short and medium term, and social cohesion in the long term.

The public holds politicians responsible for reckless public spending, which erodes the legitimacy of the political system and thereby the ability to govern. So the Europeans argue that with confidence restored the public (households) will spend more and private consumption will start to work as a driver for growth. The key to get this ball rolling is fiscal discipline.

The US, on the other hand, takes the view that the public deficit and the public debt have no major impact on confidence in the economy and in the political system. The best and quickest way to get going again is public spending, which directly pushes sales for May dropped (ECB) one of them will be right, the other will be wrong.

The decisive point taken from the US tilt towards the European view. US retail sales for May dropped 1.2 per cent. Consumer spending rose 0.2 per cent, but incomes rose by double that figure, so the savings rate increased to the highest level for eight months.

A 2008 working paper from the European Central Bank (ECB) concludes that for countries with a public deficit above 90 per cent of GDP, households react to further rises by increasing their savings. It should not go unnoticed that the US public debt right now fluctuates around 90 per cent of GDP.

When John Maynard Keynes formulated his ideas about government spending as a way out of recession in the early 1930s during the Great Depression, the economy, thus paving the way for a rise in aggregate demand, even if it does not quite look like that at first glance.

The effect on the economy depends on the accumulated effect of consumer spending and government finances. It is not about household spending or government spending, it is about total aggregate demand.

The Europeans got it wrong in the 1930s when fiscal restraint accelerated the depression, but they may actually get it right in 2010 with fiscal prudence restoring confidence in the economy, thus paving the way for a rise in aggregate demand, even if it does not quite look like that at first glance.

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