

Is it too early to be moving away from stimulus to fiscal restraint?

OTTAWA — Governments warned a day would come when they would need to tackle the most tricky and risky period of their economic recovery project. Now it's here.

With the global economy barely emerging from what was called the worst recession in six decades, governments across Europe are already putting into practice spending restraints that go well beyond withdrawing stimulus.

Other countries, including Canada, have announced plans to follow suit next year.

The drive to consolidation — the new buzzword for austerity measures being demanded of deeply-indebted countries in Europe — is emerging as the key topic of discussion and disagreement at the upcoming G20 leaders meeting in Toronto.

Even Germany, with arguably the healthiest economy in Europe, got into the act Monday by announcing plans to cut welfare benefits, introduce new taxes and shed government jobs to save about \$100 billion over the next three or four years.

But while everyone agrees governments must come to terms with ballooning deficits at some point, many analysts are questioning whether they are jumping the gun.

And getting the timing and size of consolidation wrong could be devastating, they say.

Influential economist Paul Krugman, a recent Nobel prize winner, last week referred to talk of consolidation so early in the recovery cycle, particularly with European woes mounting, as "crazy."

"What I currently find most ominous is the spread of a destructive idea: the view that now, less than a year into a weak recovery... is the time for policy-makers to stop helping the jobless and start inflicting pain."

Perhaps not surprisingly, only the United States is resisting the siren call of consolidation and in fact appears headed toward more stimulus, although Krugman says the drive to restraint is starting to impact some stimulus measures.

The danger is that removing stimulus and cutting spending too soon can pull the rug out from under the main driver of the economic recovery so far, and that's the public sector.

But many are already taking the leap. Some, like Greece, because markets won't lend them money unless they do. Others, like Canada's admittedly mild measure last week to raise interest rates one-

quarter point, because they fear the creation of inflation and asset bubbles if they keep cheap money policies in place too long.

The International Monetary Fund, which supported the weekend communique of G20 finance ministers that asked countries with challenges to accelerate the pace of consolidation, estimated 30 million jobs could be created if governments worked together on the right policies, or 30 million lost if they don't.

"What's at stake then in Toronto — the difference between good and bad policy — is 60 million jobs," said the fund's managing director Dominique Strauss-Kahn said.

But many economists are questioning whether the global economy is as strong as the pro-consolidation advocates believe, particularly with Europe likely to be mired in zero or even negative growth for years to come.

U.S.-based chief economist Nariman Behravesh of IHS Global Insight says it is far too early to be cutting public spending, adding that even Greece should be allowed some time before starting to consolidate.

"The last thing some of these economies need is fiscal consolidation," he said.

"You get into this downward spiral in which fiscal contraction makes the recession worse, which makes the deficit worse and you get into this very bad situation that is counterproductive."

The a real-world example of the consequences of getting it wrong is Japan in 1997, when it erroneously thought the economy was on the mend and raised taxes to repair its fiscal balance sheet.

Instead, the Japanese malaise intensified and wound up causing even bigger deficits.

Canada is regarded as being in a relatively cushy place with debt to gross domestic product ratios half to one-quarter the size of some of its G7 members, but its economy too could take a hit from a slowdown in global growth caused by poor policy decisions.

Scotiabank economist Derek Holt said governments are "between a rock and a hard place" when it comes to making the jarring move from stimulus to restraint.

The transition can be painful, as Canada found out in the mid-1990s when then finance minister Paul Martin pushed through a draconian program of higher taxes, government downsizing and funding cuts that went to social programs like health care. And Canada's debt problems at the time were mild compared to what much of Europe, Japan and the U.S. face today.

But Canada also caught a break in beginning consolidation as the world entered one of the greatest economic expansion periods in several generations, helping Ottawa grow out of deficit. If emerging markets are strong enough to propel global growth, Europe might also prosper through restraint, said Holt.

"My gut view is that two years from now we'll be able to say that Europe has gone through a terrible period of virtually non-existent growth, but has repaired much of the damage to their fiscal position and are better prepared for longer-run growth," he said.

"Whereas the U.S. will be exposed as having been the sleeping giant that waited too long."

But it could also go the other way. Behravesch said a more sensible path for the G20 to follow is to draft plans for austerity, but wait until 2012 before starting to implement them.

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