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Take the Austerity Cure: G-20 Should Resist U.S. Efforts to Spread More Debt Around

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Various heads of state will arrive at the G-20 summit in Seoul with sharply divergent policy prescriptions for the global economy. President Obama will urge them to keep the Keynesian party hats on by expanding budget deficits with more stimulus spending. Some other (mainly European) heads of state at the G-20 meeting, comparatively more sober and realistic, are saying that instead of more stimulus it is time to take away the deficit spending punch bowl, face the hangover, and take the austerity cure.

Conservatives who will be in leadership positions in the U.S. House of Representatives as of January 2011 should send a clear signal in advance of the summit that they agree and want the U.S. to hop on the budget-cutting wagon. The other G-20 leaders, in turn, should politely ignore President Obama's entreaties to continue irresponsible spending and, instead, show the U.S. a better example of how to achieve growth by pursuing their austerity measures with greater vigor.

Taking the Austerity Cure. Obama Administration officials, Paul Krugman, Joseph Stiglitz, International Monetary Fund economists, and other Keynesian true believers see moves towards government austerity as premature and likely to weaken the global recovery. Austerity-favoring conservatives in the G-20 group—including U.K. Conservative Party Chancellor of the Exchequer George Osborne, European Central Bank President Jean-Claude Trichet, U.S. Nobel laureates in economics (such as Edward Prescott, Vernon Smith, and James Bucha-

nan), and the leaders of several European governments—have the better answer: By reducing deficits, nations facing deepening deficits like the U.S. and U.K. can shore up confidence in their futures, encourage private investment, and accelerate their economic recoveries. In fact, the new Conservative U.K. government's dramatic cuts in spending have not been deep enough in most areas, while the excessive slashing of the U.K. defense budget will produce some undesirable outcomes for future U.K. security.¹

At least the U.K. government understands the problem and is addressing it. Leaders in Greece, France, and other European countries that have pursued unsustainable fiscal and monetary policies are also facing the hangover. Some of these governments have had no choice but to embark on a series of austerity measures to avoid sovereign bond defaults, sometimes in the face of rioting by angry, unionized public sector workers. Elsewhere, German Chancellor Angela Merkel now preaches the benefits of balancing state budgets, while everywhere in Europe banks have tightened credit standards and increased reserve requirements to more prudent levels.

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Solution to the U.S.–China Currency Dispute: Cut the U.S. Government’s Budget Deficit. U.S. Treasury Secretary Timothy Geithner’s recent push for current account targets as a cure-all for “global imbalances,” with the emphasis on China, ignores the fact that it is the U.S., as the largest economy and controller of the world’s reserve currency, which is today one of the primary creators of those imbalances. The comparatively loose monetary policies pursued by the U.S. Federal Reserve and other central banks in recent years—along with excessive and uneven global savings rates (e.g., massive current account surpluses in China and other exporting countries)—played major roles in the “extreme run-up in asset prices and misallocation of investment.”²

The Federal Reserve’s plan for a second round of “quantitative easing” (QE2) by printing \$600 billion to purchase U.S. government bonds over the next eight months is aimed at further stimulating the economy. The actual amount of stimulus, however, will be closer to \$900 billion, since the Federal Reserve also plans to roll-over an additional \$250–300 billion in mortgage portfolio proceeds into U.S. Treasury securities at the same time. In a sense, through QE2, the Federal Reserve will directly fund the federal deficit.

Defenders of Bernanke’s plan claim it that will balance the more immediate risk of deflation against the longer-term risk of inflation. Without a doubt, QE2 could result in additional dollar devaluation. Or it may ultimately prove as irrelevant to exchange rates as to domestic interest rates. The fact that the Federal Reserve is pursuing it at all may be evidence that the Obama Administration intends to proceed with deflationary tax increases on the wealthy in 2011.

The Obama Administration would like nothing more than to continue to avoid facing painful polit-

ical and budgetary choices at home by imposing responsibility for fixing the imbalances on U.S. trading partners. Unfortunately, some of those countries remain all too willing to accommodate the U.S. through fiscal and monetary expansion of their economies.

The solution that will redound to the benefit of the entire global economy is for the U.S. to reduce stimulus spending and thus set in motion a natural decline in current account imbalances. If the U.S. tries to coerce the Chinese into accepting a current account target without any offsetting action to rein in federal spending, China’s current account surplus will fall, some other country’s or countries’ will rise, and the current account deficit will remain the same.

The bottom line is that the Obama Administration’s continuing commitment to additional stimulus spending completely undermines its ostensible goal of smaller current account imbalances. Until stimulus is curbed, all that will come of the U.S. push will be a farcical effort to move the global imbalances around; they will not be reduced. That is not a responsible policy by the leading nation of the world. Other G-20 leaders should say so, publicly, at the summit. So should conservatives in Congress.

Austerity Beats Stimulus. The currency war and rise in global protectionism that could be sparked by continuing devaluation of the dollar through higher deficits and the Federal Reserve’s QE2 printing presses would certainly not serve the overall public interest. Instead, G-20 leaders should pare budget deficits to historical levels, put entitlement spending on a sustainable path in the long term, and make judicious reductions in marginal tax rates.³

1. Nile Gardiner, Theodore Bromund, and J. D. Foster, “The U.K. Budget Cuts: Lessons for the United States,” Heritage Foundation *WebMemo* No. 3043, October 26, 2010, at <http://www.heritage.org/Research/Reports/2010/10/The-U.K.-Budget-Cuts-Lessons-for-the-United-States>.
2. J. D. Foster, “Understanding the Great Global Contagion and Recession,” Heritage Foundation *Executive Summary* No. 2331, October 22, 2009, at <http://www.heritage.org/Research/Reports/2009/10/Executive-Summary-Understanding-the-Great-Global-Contagion-and-Recession>.
3. J. D. Foster, “The Fed’s Quantitative Easing and the Economy,” Heritage Foundation *Backgrounder* No. 2481, October 25, 2010, at <http://www.heritage.org/Research/Reports/2010/10/The-Feds-QE2-and-the-Economy-Sailing-to-Safety-or-a-Ship-of-Fools>.

These policies would provide an example to the Obama Administration of how austerity measures are more likely than irresponsible “stimulus” to achieve economic growth. For their part, conservatives in leadership positions in the U.S. House of Representatives as of January 2011 should signal to

G-20 summit leaders their intention to put an end to out-of-control spending and deficits by the Obama Administration.

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