G-20 orders U-turn: from stimulus to austerity

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Finance ministers from the world's leading economies have responded to the intensification of the global financial crisis over the past two months by making a U-turn on fiscal policy.

The communiqué from the meeting of G-20 finance ministers held in Busan, South Korea, on June 4-5 made clear that the fiscal stimulus packages, initiated after the collapse of Lehman Brothers in September 2008, should be ended and a new austerity program initiated.

When the finance ministers came together last April the communiqué from their meeting concluded: "In economies where growth is still highly dependent on policy support with sustainable public finances, it should be maintained until the recovery is firmly driven by the private sector and becomes more entrenched."

Today, the language is very different: "The recent events highlight the importance of sustainable public finances and the need for our countries to put in place credible, growth-friendly measures, to deliver fiscal sustainability, differentiated for and tailored to national circumstances. Those countries with serious fiscal challenges need to accelerate the pace of consolidation."

According to newly installed British chancellor George Osborne, who tried to claim credit for the change, the new words were a "significant success" in getting endorsement from the G-20 for "a significant change in tone in the language on fiscal sustainability."

The policy switch is an expression of the enormous power of financial markets and the control they exercise over government programs. The meeting received a sharp reminder of that power on the opening day, when Hungary's markets tumbled after its prime minister warned that the country was headed for a Greek-style crisis.

The eruption of the Greek sovereign debt crisis and the subsequent financial turbulence in the eurozone were the clearest signal by global finance capital that the time had come to end fiscal stimulus packages and institute a program of deepening cuts to all government social spending programs.

While the communiqué contained the obligatory reference to the "importance of international cooperation", the fiscal stimulus reversal, as well as other decisions, signified widening divisions within the G-20.

So far as government stimulus is concerned, one country's economy is another country's export market. Accordingly, on the eve of the meeting, US Treasury Secretary Tim Geithner wrote to G-20 finance ministers expressing concern that withdrawal of stimulus measures could weaken any economic recovery.

"Fiscal reforms are necessary for growth," he wrote, "but they will not succeed unless we are able to strengthen confidence in the global recovery. The challenge is to demonstrate the capacity to deliver fiscal sustainability over the medium term without creating the perception that this will require a generalized, undifferentiated, move to pull forward consolidation plans. The necessary and inevitable withdrawal of fiscal and monetary stimulus needs to be calibrated to proceed in step with the strengthening of the private sector recovery in our economies."

In other words, while fiscal stimulus needs to be reduced in the long term, if all governments simultaneously embark on such a program, it could cause a significant downturn in the world economy, under conditions where private sector demand is not sufficient to maintain growth rates.

In his letter, Geithner warned that due to the fall in US consumer demand, the American economy could not continue to absorb world exports and that "without further progress on rebalancing global demand, global growth rates will fall short of potential. In this context we are concerned by the projected weakness in domestic demand in Europe and Japan."

Other concerns were also voiced. South African official, Trevor Manuel, a former finance minister, told a press conference on the sidelines of the meeting that it was important to understand "how fragile the world recovery is." World leaders had the opportunity to "prevent the world going into a fresh recession", and he insisted that "countries that have tended to take sovereign decisions ignoring their multilateral responsibilities" start listening to outside views.

Chinese finance minister Xie Xuren urged G-20 countries to exercise caution when exiting fiscal stimulus programs. China would maintain "proactive" fiscal policies and pursue a "moderately loose" monetary policy, he said, in a statement posted on the web site of China's central bank.

There were also signs of divisions over proposed reforms to international banking regulations. The US and UK have been pushing for the introduction of regulations to increase the capital and liquidity that banks will be required to hold. But European powers have been seeking to water down or delay their introduction, for fear it would force a recapitalisation by European banks, leading to a cut in their lending and thereby opening the way for intervention by American and British banks into their markets.

French finance minister Christine Lagarde denied that France was trying to delay the process and insisted that she wanted to see it completed on schedule by the end of 2012. But in an indication of her concerns, she added: "We have to do a quality technical appraisal on the subject and that is too complicated to be rushed through."

Last month a report by Nicolas Vernon of the Brussels-based Bruegel think tank claimed that national banking officials in Europe had been covering up the "sorry state" of some major European banks, afraid that any revelation of their real position would make them takeover targets.

The G-20 meeting appears to have killed off a proposal for an international levy on banks. This had been met with strenuous opposition from Japan, Canada and Australia, on the basis that since their banks had received no direct bailouts they should not be required to contribute to a levy.

The G-20 communiqué expressed agreement that the financial sector should make a contribution to the costs of government interventions, but added that such measures should be developed by "taking into account individual country's circumstances and options". As the *Financial Times* noted, this was typical communiqué jargon used to announce the death of a proposal.