

# Age of uncertainty

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**The world may be stimulating itself out of one economic disaster and into another.**

Nothing is off the table when it comes to possible outcomes for the Australian economy and its sharemarket. Could Australia be buffeted by a spiralling global economy and a tortuously slow path back to health? Yeah, maybe. The World Bank suggested this grim outcome when it slashed its growth forecast to (gulp) a 2.9 per cent decline this year.

Could Australia be pulled along by a resurgent United States doing a V-shaped recovery and a speedy return to prosperity? Well, yeah, maybe. The International Monetary Fund has lifted its forecasts for the US economy this year and is predicting a return to growth next year.

Or how about Australia rocked as the US succumbs to hyperinflation? Or the world faltering into a great depression? Or what about the global splintering, unrest and upheaval John Maynard Keynes feared so much when he first suggested spending to ward off depression and soul-destroying high levels of unemployment?

Had a look at European unemployment rates recently? Spain, 17.3 per cent. East Germany, 13.2 per cent. Do you think they are happy campers?

Nothing is off the table. The range of possible outcomes is testament to how broken the world's financial system became last year and the great efforts central banks and governments have made to repair the ruptures.

"What they have done so far is massive," says the international economist with Macquarie Bank, Mark Tierney, of the US policy response. "No matter what you compare it to, there is no period in modern financial history that's got these kinds of unorthodox measures."

Like survivors from a terrible storm, we are having difficulty coming to terms with our new surroundings. The familiar paths we once used to follow are useless. Those paths have been wiped off the map.

"That's a problem right now: No one can rely upon recipes that worked in the past. There's a lot of guesswork going on," says Andreas Ortmann, a professor for experimental and behavioural economics at the Australian School of Business. "There's a lot of room for reasonable people to disagree on various strategies."

The extent of the changed landscape can perhaps be comprehended in the extent of the threat the global economy faced. On the weekend Lehman Brothers collapsed last September, the US Federal Reserve chairman Ben Bernanke was asked, "Well, what if we don't do anything?" He replied: "There will be no economy on Monday." Famed investor Warren Buffett has described the events of September 2008 as "an economic Pearl Harbour".

In response, we have seen governments pull out all stops, spending big as Keynes prescribed to avoid his revolutionary prediction of the worst case. In the words of Keynes's

biographer Robert Heilbroner: "A depression, in other words, might not cure itself at all; the economy could lie stagnant indefinitely, like a ship becalmed."

Keynes's prescription was to spend, spend, spend - and governments have followed this advice worldwide. The US Government debt-to-gross domestic product measure is predicted to soar north of 150 per cent, above levels reached in World War II. In Australia, a budget deficit of \$57.6 billion is forecast - the largest in peacetime.

It would be nice if we could rule out the next Great Depression as a result of such committed actions. But the evidence on a worldwide basis is muted at best. Two economists, Barry Eichengreen and Kevin O'Rourke, have tracked the current crisis against the falls that occurred during the Great Depression. Their conclusions, updated this month, are unsettling: "World industrial production continues to track closely the 1930s fall, with no clear signs of 'green shoots' as [Bernanke] had labelled the recent signals of incipient recovery; world stock markets have rebounded a bit since March, and world trade has stabilised, but these are still following paths far below the ones they followed in the Great Depression."

The main difference, they point out, is the unprecedented policy response.

Bernanke's co-authored textbook, *Macroeconomics*, gives a flavour for how far we have moved from established economic practice, with governments of all stripes printing huge amounts of money to fund the spending packages.

"Heavy reliance on seignorage [printing money] usually occurs in war-torn or developing countries, in which military or social conditions dictate levels of government spending well above what the country can raise in taxes or borrow from the public." Usually. But now is not "usually".

The sheer amount of global government spending, without precedent in history, means predictability is very low. The economy takes off like a rocket? Maybe. The huge deficits used to fund the spending create - as a natural consequence - inflation? Maybe. A long, slow, grinding recession after depression is averted, akin to Japan's lost decade? Again, maybe.

While all this may seem fatalistic, it gives some context to the huge diversity of opinions about the world economy.

Central to the future is whether we have learned anything. The philosopher Herbert Spencer once observed: "The ultimate result of shielding man from the effects of folly is to people the world with fools."

To the detriment of former Federal Reserve governor Alan Greenspan's reputation, we were all fools after the Federal Reserve "saved" the US economy from the fallout of the dotcom bubble by keeping official interest rates low and alleviating the 2001 recession.

Credit was cheap. Complicated derivatives increased the overall debt burden. Securitisation divorced lenders from the consequences of risky lending. Households took on excessive levels of debt. And kaboom.

Such recent history begs the question: are we all going to be fools again after governments spend massively to shield us from our current credit-induced folly? After all, if we rebuild the economy like it was before, won't it be the same as it was before?

This point is not lost on critics of the efforts to stimulate economic growth without substantial reform. "There's a belief that there's no fundamental problem and we have to go back to business as usual, without realising business as usual beforehand was based on an unsustainable trend in debt," the associate professor of finance at the University of Western Sydney, Steve Keen, said.

He believes we are in for economy-wide reduction of debt with a disastrous impact on growth: a 20 per cent hit on GDP in Australia and a 25 per cent hit on GDP in the US. He bases his views on an Australian private sector debt level of 165 per cent of GDP, which had risen slowly from 24 per cent in 1964. His proposed antidotes are painful and hardly mainstream, including nationalisation of banks and forgiving 75 per cent of their debts to avoid the debt trap into which he believes we have fallen.

But his point about blindly stimulating the economy without thinking of further reform is essentially sound. Do we really want to get back to "normal" when normal was anything but normal. When investment banks had 33 times leverage; mortgage brokers were given incentives to sell loans without any thought of collecting repayments; and asset bubbles went from mania to panic.

Tierney points out that rhetoric from the US President, Barack Obama, shows some recognition of the need to learn from past mistakes and depose the US consumer as the central driver of the US economy. He also sees that various policy measures have been designed to focus pain where necessary. Banks have been bailed out but with onerous conditions attached to their funding. The housing sector has not been bailed out.

In a speech to Georgetown University students in April, Obama said: "We cannot rebuild this economy on the same pile of sand. We must build our house upon a rock. We must lay a new foundation for growth and prosperity: a foundation that will move us from an era of borrow and spend to one where we save and invest; where we consume less at home and send more exports abroad."

Obama's recipe includes calls for more engineers and scientists, a reform of the failing US health system and a focus on renewable energy. How Obama gets past a bloated US consumer who loves cheap Chinese imports is going to be a considerable challenge - and it leaves economists rightly nervous.

Underlining many of the uncertainties, UBS's Australian chief economist Scott Haslem sees a sideways, stop-start recovery for the Australian economy after the global economy is stabilised in the second half of this year. But he adds the caveat: "We still have quite significant concerns about what the final source of demand is going to be for a sustainable global recovery over the next couple of years.

"What gets us out of this is what has always got us out of this: the US consumer and more recently China. Problems or imbalances that were evident in the global economy two years ago are still there in a year-and-a-half's time."

That is the same old US consumer bingeing on debt if he or she can. Tierney agreed the US Administration - and the world - face a perilous journey towards a more sustainable economy.

He is predicting a V-shaped recovery, but then a lower growth rate for the US: about 2 per cent instead of about 3.5 per cent as it attempts to transform from a consumer focus to an investment focus.

"It's a very difficult balancing act. They don't want to kick off another asset bubble," Tierney said .

The US President says he doesn't want to go back to "the bubble-and-bust economy that led us to this point". In this new age of uncertainty, there is no road map about how to do that. Watch out for bumps.

**Source: The Sydney Morning Herald**