THE IMMEDIATE aftermath of the financial crisis saw a high degree of synchronised policy response around the world as central banks eased monetary policy and banking systems were recapitalised.

As time has gone on and government deficits have expanded at the expense of sovereign creditworthiness, responses have diverged, prompting a global policy debate between austerity and stimulus.

While European nations have largely chosen, or been forced down the path of austerity, the US has unashamedly gone for growth.

Industrialising Asian economies, led by China, have also kept the stimulus taps on as they are benefiting from high trend rates of economic growth.

On the other hand, economic growth in many developed parts of the world remains anaemic and countries in peripheral Europe, like Greece, face deep structural problems and a lack of international competitiveness.

The shape of the debate took on a new hue when political wrangling threatened the US with technical default. While deficit reduction measures were passed, these were moderate.

Are we now set for a phase in which monetary policy remains historically loose in developed economies while fiscal policy is tightened?

Four years have passed since the financial crisis began in August 2007, yet it continues to cast a long shadow. The recent political spat over the US debt ceiling, which had its roots in the crisis, threatened the US with technical default until a last-minute deal was passed by Congress. With some commentators suggesting there is a case for a third round of US quantitative easing, the key question for policy-makers remains: austerity or stimulus?

Recently, governments have been taking steps to tackle unsustainable budget deficits, often spurred on by financial markets forcing the issue. Western governments have effectively been spending too much money, for too long. The evolving sovereign debt crisis in Southern Europe has accelerated deficit reduction plans, with the prospect of further contagion to come.

Interest rates remain historically low in major nations with the notable exception of China which is tightening monetary policy. Trillions have been thrust into economies around the globe in the hope of providing a sustainable growth path. Here, we consider the various approaches adopted by policy-makers.

HOW DID IT COME TO THIS?

The banking sectors of the US, Europe and the UK suffered the worst consequences of the global financial crisis, largely due to their exposure to the sub-prime US housing sector. The initial policy response to the ensuing credit crunch across these economies was similar - the use of public money to kick-start demand, recapitalise the banks and refloat asset prices. Governments took on the bad debts of the private sector, turning a financial sector crisis into a sovereign debt one.

However, more recently, the approaches of governments have diverged. At the heart of the Eurozone, in Germany and France, policymakers such as Angela Merkel are convinced austerity is the right approach. In the UK, a new coalition government chose to tighten fiscal policy in a bid to bring the country’s books back into balance. Historically, low interest rates are shouldering the strain while Britain’s fiscal austerity program bites. In peripheral Europe, the choice has largely been made for countries like Greece, Italy, Ireland and Portugal; it was austerity or bust. But on the other side of the Atlantic, the US has taken a different philosophical approach, eschewing austerity, despite a burgeoning fiscal deficit, and opting instead to chase growth.

UNCLE SAM IS GOING FOR GROWTH

The US has remained committed to very easy monetary and fiscal policy since the financial crisis. In the immediate aftermath of Lehman’s collapse, the US followed the UK in using public money to recapitalise the banking system to buy troubled assets. More recently, however, policy has diverged significantly between the two countries, most obviously in terms of fiscal policy.

The US still finds itself easing fiscal policy in 2011, largely due to the extension of the Bush-era tax cuts, in contrast to the UK and European approaches. The Congressional Budget Office suggested that the effects of the $787bn post-crisis stimulus spiked in the first half of 2010, but it is still expected to add 0.7% to the economy in the final quarter of this year.

Decision-makers in America have defended their pro-growth approach by arguing that economic expansion is an essential precondition for the successful servicing of debt. The debate escalated during the recent crisis over the US debt ceiling when political division and brinkmanship threatened to push the US into technical default.
Despite the fact that a $2,400 billion deficit reduction plan was announced, this was significantly lower than the $4,000 billion level that was suggested by Standard & Poor’s as a credible threshold. The lack of political will to choose fiscal retrenchment in the US could be partly explained by the fear of deflation and the long shadow cast by the Great Depression. However, it is also a product of the electoral cycle. With 2012 an election year, the fiscal can is simply being kicked down the road for a future administration to deal with. Meanwhile, US interest rates are set to remain historically low for the foreseeable future and the clamour for QE3 in the face of weakening growth is building.

**SILK ROAD STIMULUS**

The scale of stimulus applied by Asia in the years following the crisis has been extraordinary. Fitch Ratings has said that as a percentage of GDP, fiscal stimulus packages amounted to 6.9% for Vietnam, 7.7% for Thailand, 8% for Singapore, 13.5% for China, and a staggering 14.6% for Japan. China channelled $585bn into its economy, although the real figure was much higher since it also required state banks to lend more.

Of course, the fundamental backdrop in Asia differed significantly from that of the West. Following the 1997 fiscal and currency crisis in Asia, governments took a prudent approach, building up considerable foreign currency reserves. This meant that during 2008 they were far better placed to respond to the crisis than their US and European counterparts.

**EUROPEAN WOES**

Europe has been the main theatre for austerity. Notably, the significant tightening fiscal policy, particularly within the peripheral regions, runs in tandem with the start of a tightening cycle on the monetary front. This combination of tightening fiscal and monetary policy makes for a particularly challenging set of headwinds for European economies.

Jean-Claude Trichet, President of the European Central Bank, commented that: “Our economies are emerging from the worst economic crisis since the second world war, and without the swift and appropriate action of central banks and a very significant contribution from fiscal policies, we would have experienced a major depression. But now is the time to restore fiscal sustainability. The fiscal deterioration we are experiencing is unprecedented in magnitude and geographical scope.”

Financial markets have made European policy makers painfully aware of their views on sovereign debt ratings; with Greek, Irish, Portuguese, and most recently Italian and Spanish bond yields flashing out. The proponents of austerity would rather see risk premiums lowered through budget cuts, than face unsettling debt restructurings. However, the markets appear to be forcing the issue, demanding lasting and credible solutions to the crisis rather than what is politically acceptable. This may ultimately point towards greater fiscal union within the euro-zone and an expansion of common eurozone borrowing facilities. However, with national interests never far from the negotiating table, we may see several more twists and turns in the European debt crisis before such a solution can be reached.

**EUROZONE: SOME NATIONS ARE MORE EQUAL THAN OTHERS**

Henry Kissinger, former diplomat and US Secretary of State, once said: “When I want to speak to Europe who do I call?”. It is a question that goes right to the heart of the current eurozone crisis. The problem is Europe is not a single entity but a conglomeration of sovereign states bound by a common currency and monetary policy; critically, fiscal policy is undertaken at an individual state level. The challenge for European policy makers is applying ‘one size fits all’ policies to this diverse patchwork quilt of nations against a backdrop of self-interest. The political implications are considerable. Ultimately, power lies with the governments of the strongest individual countries, rather than institutional bodies such as the ECB; this is why we hear about “German taxpayers bailing out Ireland and Greece”.

**AN UNPRECEDENTED ECONOMIC EXPERIMENT….**

A number of commentators have pointed out that we are living through an unprecedented economic experiment. Even the economists are split, with debates raging between Keynesian and neo-Classical schools of thought. Recently, the Bank for International Settlements (BIS) weighed in to add its own voice to the debate, calling for an early normalisation of interest rate policy. With so many moving parts, it is impossible to say who is right as we are, on many measures, in uncharted territory. What we can say is there are large differences in economies, which seem to justify different approaches.

---

“The image that you should have, is not of a mountain of liquidity being spouted out of the world’s central banks, but of a hole opening in the ground, and the central banks shovelling as fast as they can to try and fill that hole.”

Trevor Greetham, Head of Multi-Asset Funds

---

“Annual income twenty pounds, annual expenditure nineteen pounds nineteen and six, result happiness. Annual income twenty pounds, annual expenditure twenty pound ought and six, result misery.”

‘The Micawber Principle’, Charles Dickens

“Make me virtuous… but not yet!”

Augustine of Hippo
In fact, this diversity of policy between countries may be no bad thing for the global economy. Perhaps the worst outcome would have been for every economy in the world to pursue exactly the same policy - be it austerity or a pro-liquidity, pro-growth strategy. The first one slows down global growth, raising the likelihood of a worldwide recession; the latter raises the prospect of significant inflation. Policy diversity can therefore be seen by investors as a good thing in terms of the overall global economy.

WHICH IS IT TO BE?

As we emerge from the worst economic crisis since the second world war, there is no simple answer to whether austerity or stimulus will best serve the global economy. It seems highly probable that both Europe and the US will need to implement fiscal adjustment, in addition to applying additional stimuli as part of a two-pronged recovery strategy.

Solutions will vary from country to country. After a long synchronised global upswing from 2002 to 2007, diversity is the order of the day. Relatively stronger economies like Germany, China, Japan, and the US, will enjoy greater flexibility than peripheral nations such as Greece and Portugal for whom the bitter pill of austerity must be swallowed at once. In countries like the UK, the US and Japan, public debt is almost exclusively denominated in local currency that the central banks can print more of if desired. In the peripheral European nations, such a luxury is simply not possible. At the root of the problem are the structural economic challenges that many individual countries face. We may need to see policymakers show a willingness to implement tough measures, however politically unpalatable they may be.

CONCLUSION: IMPLICATIONS FOR INVESTORS

As policy-makers steer through unchartered waters, investors would do well to ensure their portfolios are well diversified – across both geographies and asset classes. This is an environment where dynamic asset allocation has the potential to add considerable value. Identifying the nations that stand to benefit at the country allocation level is one approach, but investors should also be mindful of the fact that there are still good companies listed in peripheral stock markets, which can be bought relatively cheaply amid the macroeconomic gloom. Companies which, for instance, make most of their revenues in fast-growing emerging markets as opposed to relying on their country of domicile. Portfolio managers who take a bottom-up view and put a premium on deep fundamental research are well-placed to find these hidden gems and take advantage of trading conditions to access them at attractive valuations.

“With growth likely to slow and fiscal policy frozen, we expect to see a further round of monetary ease by year end and this should ultimately benefit stocks and commodities. However, barring a major upset in the markets, central banks will want to wait until inflation subsides before taking action. In the meantime, the current environment points towards holding a well-diversified portfolio.”

Trevor Greetham, Head of Multi-Asset Funds