Focus shifts to the developing world as budget cuts bite

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MAKE no mistake: the global financial crisis (GFC) has accelerated the shift of geopolitical power from the developed to the developing world.

Prior to the crisis, it was possible to dismiss the projected growth of China and India as naive extrapolations. Don't worry, we were told, sooner or later the contradictions and structural weaknesses in their economies will derail what is clearly unsustainable growth. Today, it is clear that the advanced economies of Europe and the United States should have been looking more closely at the sustainability of their own economies.

In economic affairs, the GFC has already heralded a greater role for developing countries in global institutions like the International Monetary Fund and World Bank, as well as through the newly important G20 forum. Strategically, the consequences of the GFC are now becoming apparent. In particular, it's increasingly clear that the GFC has had a profound effect on defence spending across the developed world. It is almost as if national defence has become a luxury that some countries can no longer afford. And while Australia managed to avoid the worst of the GFC, the financial crisis nonetheless dealt a hard blow to the Government's plans to modernise and expand our defence force—and there may be worse yet to come.

The core of the problem is government debt. Developed countries around the globe are struggling to get their finances in order after the Keynesian spending spree of the past couple of years. Staving off a repeat of the Great Depression turned out to be an expensive exercise. According to the International Monetary Fund, over the next five years the ratio of gross debt to GDP will grow to disturbingly high levels across much of the developed world, including Canada (70 per cent), Germany (81 per cent), UK (91 per cent), France (94 per cent), US (110 per cent), Italy (125 per cent) and Japan (249 per cent).

Even at the best of times, debts on this scale would represent massive challenges. But with insipid recoveries, high unemployment and persistent deficits in many countries, the problems seem almost intractable. And if this were not enough, rapid population ageing in the developed world, particularly in Japan and Europe, will see mounting fiscal pressures in the years ahead.

For better or worse, defence spending is one of the few areas of discretionary spending which can be used to balance the books. In the absence of a clear and present threat, it is all too easy for governments to conclude that today's fiscal woes should take precedence over tomorrow's strategic risks, especially in Europe, where protesters are taking to the streets to protect pensions and other entitlement programs.

The most dramatic example is the UK. The new coalition government under David Cameron has directed the Ministry of Defence to prepare options for cuts of between 10 per cent and 20 per cent of current spending levels. With the independent nuclear deterrent program declared sacrosanct, the UK's military leaders will have to propose dramatic cuts to its conventional force. There are no easy options, with both the JSF aircraft and aircraft carrier purchases on the table.

The situation is similar elsewhere in Europe. After already adopting austerity measures last year, Italy's military was hit with a 10 per cent spending cut in May as part of a government-wide emergency debt-reduction package. Among other impacts, Italy will probably scale back its long-planned purchase of new frigates.

Things are not much better in Germany, which plans to reduce investment in new equipment by over € 9 billion. On the chopping block are new utility and attack helicopters plus the final tranche of Eurofighters. In addition, Germany is seriously considering an

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end to conscription, which would reduce the size of its standing army from 250,000 to 160,000.

France has taken a more cautious approach, with spending cuts of between € 2.4 and 4.8 billion expected over the next four years from an annual budget of just over € 45 billion. For the moment, the cuts are described as a temporary measure with no major cancellation yet announced.

No such assurance has been given in the US, where Defence Secretary Robert Gates is looking to find $US100 billion in savings over the next five years. To show that the cuts are serious, Gates has already moved to close one of the 10 US major combat commands, slash the number of generals and admirals, and reduce the number of contractors on the Pentagon's payroll. While the total savings only represent a limited slice of the massive $US680 billion annual US defence budget, it comes at a time when a number of major weapons programs are under growing cost pressure.

If all countries were subject to the same financial pressures, the problem would not be a concern. But this is not the case; the impact of the GFC was very uneven. While Europe and the US grapple with mounting debts and sluggish growth, China shrugged off the GFC and quickly returned to growth of around 10 per cent per annum with defence spending following suit.

In some ways, the situation in Australia is more favourable than that faced by our traditional allies and partners. The GFC dealt us only a glancing blow, in part because of the quick rebound in Chinese demand for our resources. Nonetheless, the slowing of the economy in 2008 and 2009 coupled with stimulus spending has pushed the Government into deficit with a surplus not expected until 2012-13.

What's more, although the Government continues to tout a commitment to 3 per cent real growth in defence spending over the decade, the reality is very different. Just nine days after making the promise in the 2009 Defence White Paper, the Government deferred more than $8 billion of defence spending. And in the last three defence budgets, over $2.8 billion in additional costs have had to be "absorbed" by Australian Defence Force — mostly to cover the cost of operations in Afghanistan — above and beyond the $20 billion in savings demanded under the decade-long Strategic Reform Program.

For average 3 per cent real growth in defence spending to be achieved after the substantial deferral of spending due to the GFC, spending will have to rise by around 6 per cent in real terms for five years following 2012-13. It is unlikely that Defence would be able to handle such a sustained increase in funding, at least not efficiently. But that is probably the least of their worries, the prospect of still further cuts remains alive.

The Government's projected fiscal surplus in 2012-13 is razor thin, amounting to a mere $3.5 billion or 0.2 per cent of GDP, with the following year not much better. If the economy fails to grow quite as fast as Treasury estimates, the defence budget could be raided yet again. In was no accident that the Department of Finance used their incoming government brief to suggest that the Government "reassess the strategic posture and funding of defence".

While the Government has repeated its commitment to the goals of the 2009 White Paper, they appear sanguine about how long it takes. This will be especially so if the alternative is reneging on the promise to deliver a surplus in 2012-13, the last chance that they will have to deliver a surplus before the next election.

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