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Has fiscal policy lost its muscle?

HOW many bond traders does it take to change a light bulb? None: the market has already discounted the change. That old joke has taken on a new significance as the opinions of international bondholders have become increasingly important in countries with big public-sector debts. In recent years bond markets have passed votes of no confidence in several heavily indebted governments, including those of Canada, Italy and Sweden.

In theory, investors encourage errant governments to tighten their belts by demanding higher bond yields or pushing down their currencies. Yet, at the same time, the increased mobility of international capital has given governments more freedom to borrow than when they had to finance deficits in their domestic markets.

In a closed economy, if a government increases its budget deficit it has to pay higher interest rates to persuade domestic investors to hold more bonds. But once governments have access to the global savings pool, they can borrow more cheaply because even a small rise in interest rates will immediately attract overseas funds. On a world scale, bigger budget deficits will still push up real interest rates, but the domestic penalty is now smaller. It is surely no coincidence that public-sector debt in industrial countries has increased sharply, and real interest rates have risen, as the international capital market has become more integrated over the past two decades (see chart 7 on the next page). In the 30 years to 1974, total net public-sector debt as a proportion of GDP in the OECD economies fell steadily. Since then it has risen from 15% to 40% of GDP.

Under the Bretton Woods system, fixed exchange rates and restricted capital flows meant that current-account deficits had to be financed out of official reserves. That made it impossible for governments to run big deficits. Before reserves were exhausted, governments had to tighten fiscal policy to drag the current account back towards balance. Increased capital mobility has removed that constraint, allowing bigger budget and current-account deficits to be sustained for longer. Average current-account balances as a percentage of GDP in some countries have increased sharply over the past decade (see chart 8).

Thus despite economists' talk about the harsh discipline of the global capital market, that market has actually encouraged governments to be more profligate. If, for instance, the American government had had to finance the huge increase in its budget deficit in the early 1980s domestically rather than from foreign savings, then either interest rates would have had to rise by much more, or America's money supply would have exploded, causing higher inflation. Instead, America used the freedom of the global capital market to run large fiscal and trade deficits which transformed the world's biggest creditor economy into the biggest debtor.

All this might appear to weaken the argument that governments have lost economic power to the financial markets. However, recent experience suggests that the markets get their own back in the end. After indulging governments for years and allowing them to build up debts relatively painlessly, the markets suddenly decide enough is enough and turn into disciplinarians, demanding a fatter premium to compensate for the risk of default or higher inflation.

In the past, governments heavy with debt have often been tempted to inflate their way out of trouble to erode the real value of their debt. But this trick is no longer available, because investors will push up bond yields--and so raise the debt-service bill--as soon as they suspect that inflation is going up.

Certainly globalisation has restricted governments' ability to increase taxes, particularly on business. Multinationals with global investment strategies can quickly shift production to countries with more attractive tax regimes. So if governments need to cut budget deficits, they have to look mainly to public spending.

Is Keynes really dead?

The question is whether, despite all this, governments are still able to use fiscal policy to good effect. For example, can they apply a fiscal stimulus in a recession without being held back by bond-market vigilantes? The impact on output of such a stimulus will depend on how it affects bond yields. That, in turn, will depend on whether people think that such a fiscal policy is sustainable.

If a country's public-sector debt is already large and rising, then even a modest increase in government borrowing may lead to a sharp increase in bond yields, counteracting the impact on demand of the original stimulus. As public debt continues to climb, this can create a vicious circle: an increase in interest rates raises debt-service costs and hence the size of the budget deficit, which in turn pushes interest rates even higher.

If that sounds depressing, it is worth recalling that even in the good old days fiscal policy was never a wonder weapon. Governments' ability to use discretionary fiscal policy to fine-tune the economic cycle was always limited by the near-impossibility of getting the timing and size of a stimulus right. Governments typically ended up doing too much, too late, pushing up inflation.

Probably the best that governments can do is to allow so-called "automatic stabilisers" to kick in. During a recession, that means allowing spending on unemployment benefits to rise and tax revenues to fall in line with incomes and spending; the process will then automatically reverse itself in the next upturn. Simulations by the OECD suggest that automatic stabilisers (ignoring interest-rate changes) can reduce cyclical fluctuations by an average of some 40%, and sometimes much more.

However, in some countries public debt may be too high for automatic stabilisers to work their magic. If financial markets do not believe that an increase in the budget deficit will be fully reversed in the upturn, they will demand higher interest rates. Experience in the 1980s shows that their behaviour is rational: in many countries, including Britain, the cyclical increase in tax revenues during the boom was used partly to finance higher spending or cut taxes rather than to reduce the deficit. So in the recession of the early 1990s, governments such as Canada's and Italy's had to offset some of the effect of automatic stabilisers by fiscal tightening because of market concerns about rising debt.

In that situation, a reduction in the budget deficit might actually have an expansionary, not a contractionary effect. If the financial markets really believe that budget cuts will be made, bond-holders may demand a smaller risk premium from the government. The consequent fall in long-term interest rates will boost economic activity. The IMF detected evidence of this effect after Denmark and Ireland made tough budget cuts in the 1980s. Public-sector debt in both countries had previously been on unsustainable paths, pushing up risk premiums on interest rates. Their recovery suggests that credible budget cuts can help to turn a vicious circle into a virtuous one.

How much debt is too much? Neither economic theory nor economic history has a ready answer. But in many industrial economies it already seems much too high for comfort, bearing in mind future state pension liabilities as populations get older. If fiscal policy has become useless as a tool of economic management, then the blame lies with years of reckless government borrowing, not the bond-market vigilantes.

**GRAPHIC:** charts

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