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### BODY:

Wise governments learn to work with markets, not against them

IF FINANCIAL markets, imperfect though they are, cannot and should not be curbed by means of capital controls--as this survey has argued so far--then where does that leave governments? Are they now completely at the mercy of the changing whims of investors? Only up to a point. For although they can no longer affect capital flows directly, they can influence markets indirectly by conveying information.

Information is the missing link between financial markets and governments. Markets cannot be expected to be wise disciplinarians unless they have good information on economic goals, policy instruments and performance. If governments try to hold back information, markets are more likely to panic and overreact to rumours and leaks. Take Mexico. Most international economists were still bullish about the economy in the autumn of last year, partly because long delays in the publication of data had left them in the dark for several months. If investors had been better informed, they would have pushed Mexico harder in early 1994 and the market correction would have been smaller and less painful.

Investors have learnt a lesson. In future they will interpret any delay in the publication of economic statistics as a piece of information in its own right, and a good reason to sell. So the sooner governments release information, good or bad, the better for everyone.

But publication of statistics is only half the story. Economic policy, too, should be as transparent and predictable as possible. In the new financial landscape, policy-makers are surrounded by so much uncertainty that the last thing they should do is add to it. By ensuring that everyone understands what they are doing, they will minimise the risk of shocks and help to anchor market expectations. Their reward will be a reduced risk of markets overreacting to sudden changes in expectations.

One abundant source of uncertainty is often confusion about the government's policy objectives. Is the government really committed to low inflation? Will it succumb to the temptation of a pre-election spending spree? It is not enough for governments to promise to pursue sound policies; to win the trust of markets, they need to draw up their monetary and fiscal policies in ways that give incentives to policy-makers to take prudent decisions and which punishes them if they renege on their pledges. Fortunately there is no shortage of ideas on how to set about this.

### See-through policies

The best way to convince financial markets that the government intends to keep inflation low is to make the central bank independent of politicians and give the bank a mandate to pursue price stability, preferably with an explicit inflation target. An excellent model for central-bank independence comes from New Zealand, where the Reserve Bank has had full independence over the operation of monetary policy since 1990. The inflation target (currently 0-2%) is set by the government. If the Reserve Bank fails to meet that target, its governor can be sacked. The government can change the inflation target, but needs to go through parliament. That extra hoop reduces the temptation to meddle.

A growing number of countries have followed New Zealand in setting explicit inflation targets, generally within the range of 0-3% (see table 16). An inflation target committing a government to price stability is arguably as important as central-bank independence in establishing credibility for a government's monetary policy. Inflation targets provide transparency and accountability. An announced target creates a penalty for failure, reducing the temptation for governments to spring inflationary surprises for the sake of short-term boosts in output. A credible target also allows the markets to predict how the central bank will respond to unexpected deviations from target.

Transparency of the monetary decision-making process is also important. Traditionally, central bankers have behaved in secretive and mysterious ways, playing cat-and-mouse games with the markets. In the new environment, central banks must communicate clearly with financial markets if they are to influence expectations. Several countries have recently made their decision-making and operating procedures more transparent. America's Fed, for instance, last year started publishing the transcripts of its federal open market committee meetings. It now also publicly announces all decisions to change the federal funds rate, rather than leaving the markets to work it out for themselves.

In Britain, interest-rate decisions are now taken at regular monthly meetings between the chancellor of the exchequer and the governor of the Bank of England, minutes of which are published six weeks later. The Bank of England also produces an independent Inflation Report, which helps markets to understand what guides interest-rate decisions. This is an interesting experiment in conveying information to the markets. Unfortunately the message is often blurred because the Bank of England is not independent. It is the chancellor, not the Bank, who decides on interest rates, and this summer he chose to ignore the Bank's advice.

The Federal Reserve is constitutionally required to pursue both full employment and price stability. That singles it out as an oddball among central banks and makes its job harder, because these goals often conflict. Having two contradictory missions diminishes the Fed's effectiveness as an inflation-fighter. It creates uncertainty in the markets and sometimes arouses suspicion that the Fed is taking a risk with inflation. Markets are therefore more likely to react badly to news of, say, unexpectedly strong growth. An explicit inflation target would help to strengthen the Fed's credentials and calm inflationary expectations.

Inflation targets are still in their infancy, but there is evidence that they have helped to boost monetary credibility in some countries. The more credible a central bank can make its policies to the financial markets, the more flexibly it will be able to respond to changing circumstances. For example, it will have a better chance of cutting interest rates in a slowdown without triggering higher inflationary expectations and hence provoking a rise in long-term interest

rates.

Thus, paradoxically, governments' best defence against the increased clout of financial markets is to forsake even more discretionary power. By tying their own hands and so removing themselves from temptation, policy-makers will retain more influence over their economies.

#### A budgetary blueprint

Like monetary policy, fiscal policy needs to be credible to be useful. If the best cure for inflation is to put responsibility for price stability in the hands of an independent central bank, is there some parallel way of putting fiscal policy above suspicion? While governments' record on inflation has been getting better, most industrial countries' fiscal policy remains on an unsustainable course.

As populations turn greyer, the bill for state pensions and health care will explode in most countries, pushing governments deeper into debt. Chart 17 shows the OECD's forecasts of net public-sector debt over the next three decades, assuming that governments stick to their current expenditure and tax policies. For example, America's net public debt is expected to rise from around 40% of GDP in 1995 to 108% in 2030. Japan's net debt ratio is forecast to jump from 13% to 314% over the same period. The odd man out is Britain, where according to the OECD's figures net public debt will swing from 47% of GDP in 1995 to a small surplus by 2030. This is because its population is already relatively old and its public pension scheme is less generous than elsewhere.

Most countries, however, need to find a cure for their emerging debt problems. Whether that means having to make big spending cuts or putting up taxes, it is likely to be painful. Several governments have flirted with statutory fiscal rules. America tried, unsuccessfully, to reduce its budget deficit with its Gramm-Rudman-Hollings act of 1985. Last March Congress narrowly rejected a balanced-budget amendment that would have forced the government to balance its books every year. In Europe, too, the Maastricht treaty's convergence criteria for European monetary union set limits for budget deficits and public-debt-to-GDP ratios.

However, it is much harder for governments to tie their hands on fiscal policy than on monetary policy. A law that insists on a balanced budget at all times is neither politically feasible nor economically sensible. There is no fiscal equivalent of an inflation target, no simple measure of what is fiscally prudent: it depends on factors such as the stage in the economic cycle and the level of debt. For instance, budget deficits automatically widen in recessions as tax revenue falls and the bill for jobless benefits rises. If rigid budgetary rules barred these cyclical movements, recessions would be deeper. Moreover, whereas in the long term monetary policy affects only inflation, fiscal policy has a much broader economic and social impact, which makes governments (rightly) reluctant to delegate it to unelected officials. On a more practical level, experience in some American states has shown that statutory budget limits can easily be dodged by creative accounting--for example, by shifting spending programmes off-budget.

Once again, New Zealand reckons it has come up with a workable, if more modest, alternative. Its Fiscal Responsibility act, passed last year, was designed as the twin of its Reserve Bank act. It does not impose limits on the budget deficit, but creates incentives for policy-makers to act in the country's long-term interests. The act requires three things:

Proper financial accounts. New Zealand was the first country in the world to prepare proper public-sector accounts with a full balance sheet and an accrual-based operating statement of income and expenditure, much like those of a private company. The accounts are audited by a private accounting firm, discouraging fiscal skulduggery.

Conventional budget accounts conceal more than they reveal, and a public-sector balance sheet is crucial for assessing whether current policies are sustainable. It can expose common tricks such as slashing capital spending or selling off public assets which reduce the budget deficit in the short term but do little to correct the underlying fiscal imbalance. A balance sheet would encourage governments to focus on the long-term consequences of current policies, such as future unfunded state-pension commitments. There is clearly a role here for the IMF or the OECD to encourage more governments to produce proper financial accounts on a standardised basis. This would make it easier for financial markets to judge the soundness of governments' budget policy.

Explicit targets. The act sets out general principles for prudent fiscal policy which the government itself must translate into numerical targets for the budget balance, debt and public-sector net worth. For example, the act says the government must run a budget surplus until its debt is reduced to prudent levels. The government has defined "prudent" as 30% of GDP in the short term and 20% in the longer term.

Openness. The act requires much fuller disclosure of information to allow scrutiny by parliament, the public and, not least, the financial markets. The government must justify any departure from its declared target and say how it intends to get back on track. Most important, the government must publish a full assessment of its finances just before an election, which reduces the attraction of a pre-election binge.

New Zealand's Fiscal Responsibility act is not a magic cure; politicians still have to make tough choices about where cuts should fall. But by forcing politicians to make their intentions and actions more transparent, it increases the political and economic costs of fiscal irresponsibility.

New Zealand now has probably the best fiscal and monetary policy framework anywhere in the world. By itself, that does not guarantee good policy; but by making policy more transparent, it will improve the capital market's ability to impose discipline, and reduce the risk of market overreaction caused by uncertainty about policy intentions.

#### Whistle-blowers

However, some economists think that this is not enough. International economic institutions such as the IMF, they believe, also have a role to play in turning capital markets into rational disciplinarians. In the wake of the Mexican debacle, the G7 governments decided at their economic summit in June in Halifax, Nova Scotia, to widen the IMF's surveillance remit. The Fund, they agreed, should use its influence to encourage member states to produce better and more timely economic data which would allow the financial markets to form a more accurate assessment. The IMF should also be more critical and deliver franker advice to the governments of badly managed economies.

Morris Goldstein, at the Institute for International Economics, reckons that the IMF could go further. The increased clout and agility of private capital markets, he says, has put an increased premium on a well-functioning early-warning system to identify emerging exchange-rate misalignments and policy inadequacies. The main problem at present is that governments delay policy adjustments for too long, causing misalignments to get bigger. Once policies are off-track, a correction will have to be made some time. It is better to do this early, when the adjustment will be smaller and more orderly. Mr Goldstein proposes that the IMF should monitor and make public its view on countries' exchange rates and macroeconomic imbalances to encourage governments to take early corrective action.

In particular, Mr Goldstein wants the IMF to publish its annual appraisals of individual countries' policies and prospects. Once countries have significant

access to private capital and no longer require IMF money, he argues, the Fund will increasingly need to work through its influence on market opinion of countries' policies. By making the global capital market cleverer, the IMF can strengthen its disciplinary role and make it operate in a more consistent and less abrupt manner.

Private credit-rating agencies, which are already supposed to provide an early-warning system, often seem to be doing a poor job; they certainly got Mexico wrong. Publication of the IMF's country assessments would at least make it easier to monitor the IMF's track record in alerting governments to misalignments and policy errors.

The IMF, for its part, argues that if it put countries on some sort of "watch list", it would be blamed for provoking a financial crisis. Moreover, its officials claim, publishing country assessments would undermine the confidentiality and frankness of IMF consultations. But this suggests that, at present, governments give high-quality information to the IMF while withholding it from the credit-rating agencies. If governments want financial markets to work more efficiently, then the sooner the markets know the full facts, the better.

"The Exchange Rate System and the IMF: A Modest Agenda", by M. Goldstein, IIE paper no. 39

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