POLICY OPTIONS FOR ADVANCED ECONOMIES IN DISTRESS

Ben Vosloo argues that governments in the advanced world must balance budgets and create a climate for enterprise if recovery is to occur

Many developed economies are in serious distress: They are drowning in their debt while simultaneously facing very weak economic growth prospects. They have for many decades been living above their means, financing generous welfare benefits and bloated public sector bureaucracies by way of chronic deficit budgeting. Based on current trends, the accumulated government debt of developed economies can be expected to reach an average of 120% of GDP by 2015. The resource-based Canadian and Australian economies and the industrious Germans are among the better performers. But for the bulk of advanced economies, including the United States, Britain, France, Italy, the Netherlands, Sweden, Belgium, Norway, Denmark, Finland, Austria, Spain and Japan, the average growth rate for 2011 and 2012 is not expected to rise above 1.5%. The containment of government debt levels requires sharp reductions of budget deficits and healthier growth rates close to 4% per annum to lift their taxable income levels.

The average growth rate of every major advanced country has been declining for several decades. Only resource-based economies like those in Australia and Canada have grown. The economic stagnation afflicting the advanced economies manifests itself in many ways: unemployment rates around 10%; chronic budget deficits with levels of government spending approaching (and exceeding in several cases) 50% of national output; social welfare systems placing an unsustainable tax burden on society; public debt levels creating 'debt traps' where a government has to pay more interest than it can service; and inflationary expectations undermining confidence.

Most economic analysts agree that the global financial crisis of 2008 was largely triggered by the dodgy financial engineering of the Wall Street financiers, who contaminated financial institutions throughout the developed world with their toxic securities. This contamination gave rise to a liquidity crisis that required governments to step in to recapitalise struggling banks, provide bridging finance to jobs-shedding enterprises, provide fiscal stimulus to shore up demand levels, and reduce interest rates to enhance credit facilitation. The global economy was pushed to the edge of deep recession. The crisis gradually transformed into a persistent and contagious contraction in the advanced economies. This contraction has been accompanied by persistently high levels of unemployment, stagnant business expansion, depressed confidence levels, and sclerotic growth patterns.

When the global financial crisis struck in 2008, most advanced economies were already vulnerable to contagion on several fronts. Government debt levels were already unsustainably high as a result of the cumulative effect of deficit budgeting over many years.

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Governments were already committed to high levels of spending on welfare benefits, public sector employment, and defence and security spending (particularly in the case of the United States). Private households were also saddled with high debt levels as a result of their deep-rooted addiction to using credit financing to purchase housing and consumer goods—euphemistically called 'leveraging.'

The lingering hold of the socialist mindset among large segments of the intelligentsia and rank-and-file populations in advanced nations created a misconception of the real value-adding sources of wealth creation and progress in society. The result was general ignorance of the scope of the emerging challenges. Mentally and institutionally advanced societies were incapable of confronting the imbalances and discrepancies in their fractional reserve banking systems and their reliance on supra-national bond markets and capital flows. Their regulatory frameworks were ill-equipped to manage the risks associated with the debt to equity ratios of its financial institutions. Policymaking bodies such as political parties, pressure groups, and representative rule-making institutions were unable to understand the emerging challenges and even less equipped to take decisive remedial action. The result was decision-making paralysis and policy drift.

To repair their damaged public finances, heavily indebted governments will have to lay out a restoration strategy to tighten their budgets by cutting spending and raising as well as efficiently collecting taxes. Banks will have to be required to stick to their key role in financing individuals and companies to expand their business enterprises, refrain from proprietary trading and speculative activities, and keep adequate capital cushions to cover their lending activities. They should be reined in and forced to stick to their proper role: financing the real economy and not involving themselves in speculative financial bubbles and stratospheric incentives. Governments need to stay within the parameters of prudent budget rules: reducing the deadweight of public bureaucracy and balancing their budgets. These changes will have serious political, social and economic implications and will take decades to achieve. It requires national as well as community leaders with a long-term perspective—and electorates that give support to leaders who look beyond the next election.

The sad reality is that major left-wing segments of the electorate in the advanced economies are so addicted to the culture of entitlements and redistributive handouts that they are not prepared to accept the deficit-cutting and structural reform measures that are a *sine qua non* for economic recovery and growth. They are ill prepared to face the stark reality of national insolvency and refuse at their own peril to swallow the required medicine—an electoral frame of mind that does not bode well for the immediate future. The last time advanced countries faced hardships and mountains of public debt was during and after World War II when the general populace and their leaders were inspired by a dedicated spirit of reconstruction and development to build a better future.

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Reducing debt burdens

Reducing their excessive debt burdens is a *sine qua non* for all advanced economies. The Maastricht treaty's fiscal criteria for monetary union prescribed that total government debt should be no more than 60% of GDP and that budget deficits be no larger than 3%. But these generous rules were easily broken by EU countries—even Germany—without receiving any punishment. Based on current trends, total government debt in the EU countries is projected to be heading towards 125% by 2015. These levels of debt are unsustainable, especially when nervous capital markets and speculators drive up the cost of the growing debt. Official deficit and debt levels are exacerbated by the over-extended bank debts and private sector debts on top of the overweight public sectors.

The critical variables are the level of confidence of the buyers of government bonds, the interest rates required to buy government debt, and the repayment terms involved. These requirements, in turn, depend on perceptions of the relevant government's fiscal rectitude and the economic potential of a country and the willingness of its taxpayers to shoulder the commitments made by its government. A country with a firm growth potential, a stable political system, and a convincing record of sound economic management is more likely to raise loans domestically or internationally to cover its debt requirements. The ability of a country to service its loans depends on its projected disposable income stream.

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To avoid public debt spiralling out of control requires raised taxes, reduced spending, and a higher growth rate. But in several EU countries, the tax base has been eroded by the economic downturn while their expenditure budgets remained committed to unaffordable welfare entitlements and ballooning public sector emoluments. Hardly any Eurozone country is now optimistic about its growth prospects.

Most European economies have seen average growth below 2.5% over the past two decades. If growth declines below the level of real interest rates, debt burdens will continue to rise. The debt level becomes excessive and unsustainable when a vicious cycle is set in motion: Rising debts boost interest payments, which in turn require extra borrowing to service earlier debts and so on. Governments then have only three ways to break away from the debt trap: raise taxes, slash spending, or let inflation rip (e.g. by 'quantitative easing' or printing money if they are not part of a monetary union and/or the central bank agrees to buy the debt of delinquent governments). If the above measures are exhausted, the only remaining option is default—and eventually failed state status, unless debt restructuring can be arranged with creditors taking a 'haircut.'

There are distinct trade-offs attached to each policy option. Servicing the national debt with tax rises could damage the economy by reducing incentives to work or by causing distortions in investment patterns resulting from reduced income and savings levels. Government borrowing also tends to reduce private investment—and so reduces the capital stock that future generations have to rely on, causing a lower standard of living. The reason is that government absorbs the savings that would otherwise have gone into more productive investment. The impact of the 'crowding out' of private capital formation largely depends on the productivity of government spending. Financing welfare payments and public sector emoluments at the expense of productive investments constitutes a major burden, whereas financing a new road, railroad or harbour development is likely to be a boon. Fiscal adjustments that rely on spending cuts are more sustainable and friendlier to growth than those that rely on tax increases. Cutting public sector wages and transfers is better than cutting public investments in infrastructure. Spending cuts achieved by raising the pension age and slashing farm price subsidies have the double benefit of improving public finances and boosting economic growth through raising productivity and promoting more efficient resource allocation.

In the current situation, several advanced economies have dealt with their accumulated debt burdens in different ways. Japan, the country with the highest debt burden in the world, has raised its loans from the frugal savings of its domestic population. In addition, it still benefits from the export prowess of the Japanese economy, the productivity of its manufacturing sector, and its skilful foreign investments and low-cost manufacturing abroad. The United States has managed its huge sovereign debt levels by virtue of the US dollar being the reserve currency of the world and the size and sophistication of its financial market. It has

managed to sell the bulk of its Treasury bonds in China, Japan and Middle Eastern countries. All countries running current account surpluses happily park their capital surpluses in US bonds—in lieu of other reliable destinations. The United Kingdom relies on the City of London to provide banking and other financial services to many parts of the world—particularly to EU countries. The United Kingdom prefers to exploit the benefits of an open EU market without the obligations imposed by Eurozone integration. Switzerland has traditionally been a 'haven' for unrecorded fortunes with its system of 'numbered accounts.' These destinations for surplus capital are increasingly challenged by new competitors such as Luxembourg, Hong Kong, Singapore and several Caribbean Islands. In the case of Greece, solutions to its debt problems are sought in a combination of fiscal and monetary austerity measures and seeking bailout assistance from Eurozone partners. Seeking debt restructuring and bailout assistance, and perhaps, eventual default, implies deflecting the crisis back to the bondholders who provided the credit in the first instance!

The bond holders and their camp followers are keen to see the 'mutualisation of government debt,' i.e. for Germany and other creditor countries to step forward to commit themselves to ring-fencing 'solvent' governments; to beef up rescue funds (such as the European Financial Stability Facility or EFSF), to support the issuance of euro bonds, which would be less vulnerable to speculation and to authorise the European Central Bank (ECB) to buy the debt of wobbly countries such as Italy, Spain and possibly even France. No practical proposals have been advanced so far to ensure that delinquent borrowers do not continue to exploit these facilities by running up more debt for others to guarantee—or to write down.

Spending cuts and tax rises

A crucial decision in the highly indebted countries is determining the nature of the mix of spending cuts and tax rises that are required. It is clear that spending cuts would be better for their economies than adding substantially to the tax burden. It is also more likely to produce healthier fiscal outcomes. A state that has over-expanded for decades is seriously in need of vigorous pruning. Spending cuts are certainly a source of misery for all the beneficiaries of governmental largesse, but they are essential for remodelling the leviathan state—shedding some functions altogether and retaining the more efficient ones. Spending reviews are essential in the armed forces, public-sector earnings and pension benefits, welfare entitlements (child benefits, free bus travel, transfer payments on electricity and fuel bills), tax-free concessions, etc. A sound approach would be to require justification for all programs from scratch. No activity should be immune from 'zero-based budgeting.'

> But the best way to increase the size of the tax base would be through economic growth. Ideally, a tax system should raise revenue in a manner that is efficient, fair and conducive to economic growth.

Rising levels of government spending on regular as well as ad hoc entitlements, have a remarkable staying power as a result of populist political pressure for their retention and expansion. Hence the expansion of all public expenditure needs to be scrutinised with a sharp eye. 'Handouts' should be limited to those in dire need. Wasteful and corrupt use of public money (e.g. in the allocation of government contracts) must be avoided at all cost. The creeping culture of entitlement must be confronted by all responsible opinion leaders.

Although spending cuts should bear the brunt of fiscal reform, the holes in the budgets of advanced countries are so large that tax increases will be hard to avoid: income tax on individuals, taxation on the profits of companies, and indirect tax on the sale of goods and services. The least damaging way to raise tax revenue is to tax consumption, preferably by broadening the base by reducing exemptions. The available options to increase tax revenue are either to increase the tax base, or to increase the

efficiency of tax collection. But the best way to increase the size of the tax base would be through economic growth. Ideally, a tax system should raise revenue in a manner that is efficient, fair and conducive to economic growth. Closing loopholes also results in a broader tax base and increased revenue for a given tax rate.

> On balance, the history of policies aimed at managing aggregate demand is not encouraging. Because of time lags and misdirection of deficit spending, both recessions and inflationary pressures can be exacerbated by fiscal intervention.

Keynesian anti-cyclical demand management

John Maynard Keynes started from the assumption that in times of economic uncertainty, savings will exceed investment and aggregate demand will fall short of aggregate supply. Hence it is the duty of government to counter the 'market failings' by judiciously applying economic policy. Keynes provided the theoretical foundation for the demand-management policies that are today considered the essence of Keynesianism, which boils down to the idea that an economy can be revived by stimulating aggregate demand. As demand rises, prices and output are likely to rise as buoyant business conditions are reflected in rising profits and falling inventories. Business enterprises will respond by increasing output and employment. If aggregate demand is less than expected, businesses will experience rising inventories and falling profits, and reduce employment and output accordingly. Thus economies decline if there are deficiencies in aggregate demand.

The working kits of modern econometrics provide a variety of analytical devices used by Keynesians to interpret national accounts and economic trends to formulate policy proposals. The most important are anti-cyclical fiscal interventions to manage demand aiming at stabilising the cyclical variations of the economy. It is particularly relevant to take a closer look at the impact of the 'multiplier effect' of government spending and the role of the 'automatic stabiliser' as fiscal devices to be used as part of discretionary fiscal policies.

The theory behind the 'multiplier effect' is that an increase in demand (as a result of government stimulus) will initially boost income by an equivalent amount. This increase gives rise to further rounds of demand stimulus and output growth. This 'multiplier' is driven by the marginal propensity to consume, i.e. people spending a certain portion of their income on consumer goods and services. Thus injections of government spending could have a magnified effect (Keynes called it a 'cumulative force') on economic output if it stimulated available resources into productive use.

Keynesians maintain that government is the only institution in society with the ability and incentive to promote demand on a large scale over a wide range of products and for an extended period. Franklin D Roosevelt's New Deal programs created demand on a large scale over several years that led to strong economic growth in the United States. Similarly, World War II, with its huge war expenditures, illustrated the effectiveness of fiscal demand management on a large scale. For many, this was proof that the policies proposed by Keynes could work well. Optimism over macroeconomic government intervention became widespread. As a consequence, a strong arsenal of Keynesian policy instruments was developed.

Throughout the post-War boom of the 1950s and 1960s, governments acted on the assumption that the state could regulate aggregate demand and ensure full employment. This 'Keynesian' policy hegemony was curtailed by the rise of inflation in the 1960s and 'stagflation' in the 1970s. Extended periods of deficit spending generated a disease that Keynes never anticipated. It was called 'stagflation' because it entailed stagnant growth, unemployment and rising prices. It illustrated the practical difficulties of applying fiscal expenditure decisions timeously and in correct quantities. Experience also showed that monetary measures are very blunt instruments.

In the wake of the global economic meltdown in 2008, the world saw the biggest fiscal expansion in history. Across the world, countries sought to counter recessionary pressures by cutting or keeping taxes on hold and by boosting government spending in terms of their 'fiscal multiplier' expectations. During the fiscal years 2009 and 2010, the G20 economies introduced stimulus packages worth an average of around 2% of GDP. It is not clear how well, or indeed whether, such stimulus packages work. The question hinges on the scale of the 'fiscal multiplier' which, in turn, depends on a range of economic factors such as the scope of spare capacity and the ability of an economy to spur its productive factors (capital, labour, natural resources, technology and entrepreneurship) into action. The multiplier is also likely to vary according to the type of fiscal action (e.g. national infrastructure projects versus consumer spending on imported goods). It also depends on whether governments finance their stimulus spending through taxes or loans.

On balance, the history of policies aimed at managing aggregate demand is not encouraging. Because of time lags and misdirection of deficit spending, both recessions and inflationary pressures can be exacerbated by fiscal intervention. Governments tend to become addicted to 'welfare on credit' payments and thus render fiscal policy more disruptive than constructive. Not all expenditures or taxes have the same multiplier effects. Continued deficit financing has 'crowding out' effects on private investment and expenditure, while rational expectations of consumers may neutralise the multiplier effect of a government's deficit spending. A major problem associated with fiscal expansion is the resulting public sector growth, which increases inflationary pressures. Since a large portion of all government spending (more than 50%) is absorbed by the running costs of institutions paid out of the public purse, it escalates institutionalised inflation to levels that are not easily reversed. Experience has also shown that the *automatic stabiliser* effect of economic growth on government revenue can only be triggered when actual economic growth takes place. It is not a significant policy tool in a sclerotic economy.

Unconventional monetary policy

According to the monetarist theories of Milton Friedman and others, central banks can manipulate economic growth patterns by raising or lowering interest rates (using 'open-market operations' by buying or selling securities or by 'announcement effects') and by 'quantitative easing' (a practice pioneered by the Bank of Japan in 2001 and more recently followed by the US Federal Reserve), which involves, *inter alia*, buying government debts or other assets with newly created money. These 'unconventional' monetary policies are intended to positively influence government borrowing costs, money supply, credit levels, price levels, equity prices, exchange rates, the balance of payments, and the growth rates of an economy.

The actual results of these new 'unconventional' measures as applied in one form or another in Japan, the United States, the United Kingdom, and the European Union are not clear. After four years of contractionary pressures since the start of the global financial crisis in 2008, central banks in the advanced economies have kept interest rates close to zero to stimulate demands, used quantitative easing to push liquidity into the government sector as well as the banking and corporate sectors, and in the process, ballooned their own balance sheets with a range of paper assets. It is difficult to isolate with certainty the impact of these measures on the broader economy—on household debt levels and on contractionary pressures in grassroots business activity or employment levels. The downside dangers are obvious: the distortion of the future ability of central banks to rein in inflationary pressure, the distortion of the borrowing costs of profligate governments, and the diminishing returns of continued bursts of quantitative easing.

Managed inflation

In terms of monetary theory, inflation occurs when the quantity of money increases faster than the growth in output. In terms of real life experience on the community level, it means a general decline in the purchasing power of money because of the rise in prices of goods, labour, property—of everything. Letting inflation rip raises serious questions.

Can the churn of inflationary pressures be roped in to unleash growth in a sclerotic economy? Is a little inflation a good thing for the economy—spurring growth momentum by enhancing confidence, raising expectations, promoting consumer spending, and encouraging investment? Would inflationary pressures replace hoarding instincts with expectations of a better future by bidding up prices and boosting production? Or is stripping inflation from our national accounts akin to chasing 'fool's gold'? Can runaway inflation be avoided or tamed?

Economists generally consider wage and salary increases, higher food prices, higher energy prices' and depreciating exchange rates as 'cost-push' factors causing inflationary pressures on the supply side of the economy. The 'demand-pull' factors precipitating inflationary pressures are increased money supply, generous credit extension, lowering interest rates, and other measures fuelling consumer spending. Normally, the interaction of these factors drives inflationary pressures along a circular path. Increased government spending financed by government borrowing (normally through a central bank expanding the money supply by buying government bonds) gives rise to inflationary expectations, which in turn, spur pressure groups to demand higher prices for labour and goods. So the inflationary pressures keep spiralling along, securely buffeted by inflation-indexed wage (or salary increments) and inflation-indexed, government-funded welfare entitlements. The pace of this spiral normally outstrips the pace of real growth in output which, if unrestrained, can escalate into hyperinflation.

It is important to consider the undesirable effects of inflation. Most importantly, it creates uncertainty that undermines business confidence and depresses investment in economic expansion. It alters the rewards accruing to the different types of economic activity (e.g. consumers, producers, workers, savers, investors, entrepreneurs), leading to weaker output and lower real income levels. By eroding the purchasing power of money, it reduces the value of fixed wages and salaries, fixed pensions, and interest on fixed deposits. It induces redistribution from lenders to borrowers if nominal interest rates do not fully compensate for inflation. Volatility in inflation expectations creates uncertainty regarding economic prospects and hence militates against investment in productive assets. It enhances speculative activities which crowd out production.

For several decades, some form of inflation targeting has been adopted as a policy objective in most advanced economies. The main purpose being to reduce inflationary expectations by providing a credible anchor for economy-wide price and wage adjustments. It also provides a yardstick for assessing current economic trends and promoting transparency and accountability in the conduct of government monetary and fiscal policy. It also helps the general public form more accurate expectations about inflationary trends. A low and stable rate of inflation creates a stable financial environment, which is crucial for sustainable growth and equitable distribution of resources.

Downsizing the public sector

In all advanced economies, during the past half century, government sectors have grown faster than the private sectors—the ultimate source of taxable income. For a brief period from the mid-1970s to around 2007, several advanced countries saw a small decline in the rate of increase in the share of government spending as a percentage of GDP. However, since the onset of the downturn in mid-2008, government spending on stimulation packages shot up at an unprecedented rate. Post-crisis expenditures simply levelled out on a higher plateau than pre-crisis expenditures. The impact of these expanded activities has so far not been properly measured and evaluated independently. It is clear that the cost of these government interventions will be felt in many ways: requiring governments to continue to rescue banks, to slash interest rates, to intervene in markets, and to run large deficits. That means the moral-hazard problem takes on gigantic proportions.

It is essential to realise that government cannot turn around the lack of economic growth—it can only alleviate or cushion the unfavourable effects of a severe downturn in the short term. Growth

depends on business activity—producing goods and services for which there is a realistic market, either nationally or internationally.

Ironically, it is the private sector that bears the brunt of an economic downturn. Private sector employers are subject to the discipline of the 'bottom line' as determined by market conditions to survive—and ultimately to the 'iron law' of the insolvency act. Hence, the private sector employee is constantly subject to productivity standards and is the first to be retrenched, be required to work fewer hours, or forfeit wage increases. In contrast, public sector employees, who in most Western countries represent about 20% to 30% of the total workforce, are not subject to stringent productivity standards, retrenchment or salary reductions. Their emoluments are, on average, much higher than the private sector and a very small proportion are temporary or part-time workers. In contrast, a very small proportion of private sector employees are high-flying CEOs or professionals or investment specialists with flourishing bonus-driven packages.

Curtailing union power

The United Kingdom is a prime example of the impact of trade union power on a country's growth pattern. During the period between 1913, when the *Trade Unions Act* was passed, and the 1980s, when Margaret Thatcher introduced curtailments of union privileges in the Employment Acts of 1980 and 1982, British trade unions exercised excessive power and enjoyed excessive privileges. They eventually brought the British economy to a standstill. They changed Britain from a prosperous minimum-government state to a country where public expenditure accounted for around 60% of GDP in 1980.

In today's world, the 'trade union movement' is dominated by 'public sector employees' who are well placed to dominate the collective bargaining process. Many political leaders who are supposed to represent taxpaying electorates, are also, in effect, ex-employees of the government sector or ex-executives of the trade unions. The beneficiaries—public sector employees and their families—form around 25% of the total electorate. This stranglehold does not bode well for the future of both representative democracies and free-enterprise economies. A self-serving bureaucracy could destroy the creative potential of society.

> They can only avoid the bleak scenario of seeing their economies spiral downwards by balancing their budgets and by creating a climate for enterprise that would allow entrepreneurship to ignite the engines of economic growth.

Austerity and growth

Recently, the EU policy debate has shifted towards a false dichotomy: choosing between austerity and economic growth as if they are mutually exclusive. The Merkel government in Germany is identified with austerity as a necessary part of Europe's healing—cutting wasteful spending and working harder and longer. The anti-austerity camp is essentially driven by the recipients of government largesse and the mouthpieces of the bondholders who are making money out of deficit-spending governments. Germany has been trying to persuade European leaders to agree to a 'fiscal pact' that would toughen budget rules and enshrine balanced budgeting in national constitutions, monitored by the European Court of Justice. Opponents argue that although such a pact might help prevent future crises, it would do little to halt the current one. Egged on by its banking interests, the United Kingdom wants the ECB to buy as many sovereign bonds as it takes to calm bond markets, that is, the mutualisation of the Eurozone government debt with Germany providing supportive guarantees.

Chronic deficit spending at unsustainable levels has been the prime cause of the economic quagmire in the first place. At best it could be argued that austerity measures to decrease debt should be systematically phased in and accompanied by efforts to accelerate growth. The mountains of debt have been accumulated over many decades and it would require a massive cultural change to turn around the weak growth

potential of the advanced economies. It requires a rediscovery of the real sources of economic growth: striving to become more industrious, self-reliant, innovative and entrepreneurial. They must use their resources in new ways to heighten their efficiency, effectiveness and productivity. Rewards must be tied to productive efforts.

Concluding remarks

Unfortunately, no amount of modern computerised modelling can tell us how deep and how long the economic meltdown is likely to be. What we do know with certainty is that there is no long-term future in short-term 'gravy-train' handouts. We know that sound government policies, an appropriate rate of savings, a high rate of productive capital investment, a skilled and non-disruptive labour force, and the availability of strategically important natural resources have a vital role to play. We also know that throughout the world, free-enterprise economies have consistently outperformed socialist command economies in terms of higher levels of health, life expectancy, and income.

Can the advanced nations re-ignite their powers of recuperation and renewal? They can only avoid the bleak scenario of seeing their economies spiral downwards by balancing their budgets and by creating a climate for enterprise that would allow entrepreneurship to ignite the engines of economic growth and prosperity for all. Those who habitually clamour for more collective action by national or supra-national governments should do well to heed the words by Samuel Johnson written more than two centuries ago:

> How small of all that human hearts endure
>
> That part which Laws or Kings can ... cure.

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