The Economist

The unkindest cuts

Many countries face the difficult choice of upsetting the markets or upsetting their voters

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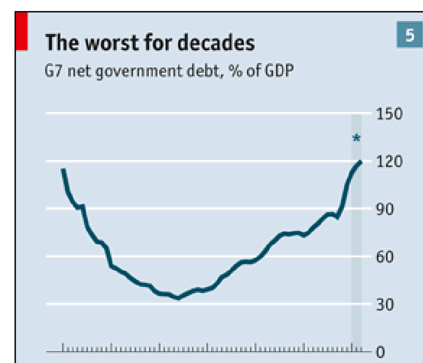
CALL it the rich-uncle theory. When the private sector struggles, governments often step in to pick up the bill. And when individual countries have trouble meeting their commitments, they turn to their neighbours, or to the International Monetary Fund, for help.

The recent recession, and the financial crisis that precipitated it, have led to a sharp increase in government debt in the developed world, on a scale virtually unprecedented outside world wars. For some states this burden has arisen at a time when their finances were already stretched. And for most countries in the rich world this has happened when they are having to face up to a range of problems associated with ageing populations.

Countries have long had a complicated relationship with their national debt. It was the need to repair its national finances that forced the *ancien regime* of Louis XVI in France to summon the Estates-General in 1789, an event that triggered the French revolution. In his book, "A Free Nation Deep in Debt", James Macdonald argues that the national debt was a source of strength for countries such as Britain and the Netherlands, whose governments were financed by merchants and bankers. In wartime such countries could easily outspend those run by aristocrats, which had a history of default. For Britain and the Netherlands there was no incentive to default on the debt owed to the classes that controlled them.



During the first and second world wars governments on both sides of the conflict exploited the patriotism of their citizens, persuading them to buy "victory" bonds and the like. Those same governments then penalised the patriots by inflating away their debt after the war. From 1945 onward government debt became a tool of economic management as Keynesian deficit spending was used to cushion economies during recessions. The booms of the 1980s and 1990s led to a surge in tax revenues and kept the debt problem under control. But the recent financial crisis caused some of the

biggest deficits recorded in peacetime. The debt-to-GDP ratio of the G7 group of nations is at its highest level for 60 years (see chart 5).

That has started to raise questions about whether countries can actually meet the bill. Allowing governments to assume debt has some obvious advantages. If companies, and in particular banks, go bust, they cause a lot of knock-on social costs, including lost jobs and consumer uncertainty.

Governments are much less vulnerable to credit runs because they can raise taxes and print money to buy time for the debt shock to be absorbed. Governments also find it easier to fund deficits during recessions, when nervous investors are only too happy to shelter behind the safety of government bonds. But in the long run deficit financing is the equivalent of a private individual getting a new credit card and making the minimum repayment every month. For a while it seems like free money. The tricky point comes when the credit limit is reached.

For governments, that credit limit can vary enormously. One reason why the crisis has hit the euro zone before other regions is that its countries have renounced the money-printing and devaluation options by adopting a common currency. In some ways the problems facing euro-zone members are akin to those facing countries on the gold standard in the 1930s. They had to choose between imposing austerity to maintain the standard or repaying creditors in devalued currency. The countries that went off gold soonest tended to recover fastest. But abolishing the link to gold was far easier than it would be to replace, say, the euro with a new drachma.

With luck, today's government deficits will be temporary, gradually disappearing as the private sector comes to the fore again. Countries recovered from even bigger government debt burdens after the second world war. But at that time the personal, industrial and financial sectors of the economy were much less indebted.

Economists are still arguing about how quickly to cut government deficits. Earlier this year the different schools sent rival letters to the *Times*, discussing the suitability of early efforts to cut Britain's budget deficit (the new coalition government announced cuts of £6 billion in May). The fear is that higher taxes and spending cuts will cause job losses and hit demand at a point when the economy is still fragile.

The doves contend that the first priority should be to stimulate growth, since that will automatically raise tax revenues and cut expenditure on items such as unemployment benefits. The hawks counter that there comes a point when further deficits are self-defeating. Carmen Reinhart and Kenneth Rogoff suggest that the crunch arrives when the debt-to-GDP ratio reaches around 60% in emerging markets and 90% in developed economies. In rich countries median growth rates tend to fall by around one percentage point a year once that limit is reached.

When debt gets too high, a number of problems arise. First, a spiral is set off in which lower credit ratings for a country lead to higher borrowing costs, in turn increasing the deficit. Markets already seem unwilling to fund some countries at sustainable rates: by the time Greece turned to the IMF and its EU partners for help, its short-term bond yields were nearly 20%. Ramin Toloui of PIMCO, a fund-management group, explains the process this way: "When government debt reaches extreme levels, concerns about government creditworthiness become so severe that additional government spending produces increases in long-term interest rates that exacerbate, rather than ameliorate, the economic contraction."

Second, once a country is stuck in this debt trap, it has to bring in austerity programmes to reduce the deficit; but such austerity holds back economic growth because higher taxes and lower

spending reduce demand. Like the Red Queen in Lewis Carroll's "Through the Looking-Glass", the country has to run as fast as it can just to stand still. Ireland has been the good boy of the sovereign-debt markets, taking quick action to reduce its deficit through measures such as cutting public-sector pay. But other countries may not be in a rush to emulate it: its nominal GDP has fallen by over 16%.

Third, larger government deficits imply greater government interference in the economy and thus a less efficient use of resources. One study found that each percentage-point increase in the share of GDP devoted to government spending reduced growth by 0.12-0.13% a year.

Last, according to the doctrine of Ricardian equivalence, consumers and businesses see larger deficits as the precursor to higher taxes in future, so they save more of their income, meaning that pump-priming by the government ceases to work.

Even those governments that are tempted to keep stimulating the economy may find that the markets punish them for it. Once a crisis of confidence has occurred, governments find it difficult to raise the money they need at an acceptable interest rate. A report by an economic adviser to the Bank for International Settlements in March noted that "our projections of public debt ratios lead us to conclude that the path pursued by fiscal authorities in a number of industrial countries is unsustainable. Drastic measures are necessary to check the rapid growth of current and future liabilities of governments and reduce their adverse consequences for long-term growth and monetary stability."

Countries that decide to embark on deficit reduction may face another problem. According to Andrew Smithers of Smithers & Co, a consultancy, a debt-cutting policy will make it harder for the government to bail out the private sector in times of need, as well as reducing companies' cashflow by imposing higher taxes.

An even bigger problem may be the unfunded liabilities that government face from ageing populations. This is a double burden: benefits for growing numbers of pensioners will have to be paid for by a shrinking band of workers. These liabilities are difficult to calculate. Pierre Cailleteau of Moody's, a rating agency, says that "the state of public-finance accounting is extremely rudimentary relative to private-sector accounting."

A 2009 report by Jagadeesh Gokhale, of the right-wing Cato Institute in Washington, DC, estimated that the average EU country would need a fund worth 434% of its GDP, earning interest at the government's borrowing rate, to meet such liabilities; alternatively, it would need to save 8.3% of its GDP each year. Neither seems realistic. The only answer is to cut future benefits. But the elderly form a powerful voting block, with a higher turnout than their children, who will pay the bill.

European extremes

Neither Greece nor Iceland has had any choice about tackling its deficits. They may be a long way apart, both geographically and culturally, but both are casualties of the debt crisis. Iceland was the little country that could. A land with just 300,000 people, best known for its volcanoes and its fish, it privatised its banks and suddenly became an international financial powerhouse. "In the Icelandic system, all the banks were aggressive broker-dealers like Bear Stearns and Lehman," says Asgeir Jonsson, an economist and author of a book, "Why Iceland?".

A high exchange rate encouraged its corporate sector to go on an overseas acquisition spree. Its housing market boomed as fishermen took out cheap loans in euros and yen. The country became

an egregious example of the excesses of financial liberalisation. Its politicians failed to halt its debt spiral because its citizens (and particularly its elite) seemed to be doing well out of the boom. Houses doubled in price, the strong krona allowed its people to go shopping in London and its billionaires to buy British retailers and football clubs.

Greece, for its part, was not noted for an aggressive banking sector or a housing boom. It was traditionally dismissed by investors as a country of high inflation and repeated devaluations. When it joined the euro zone in 2001 it reaped an immediate dividend in lower interest rates, but it failed to tackle its underlying problems.

Dodgy accounting disguised the size of its government debt. Its businesses remained uncompetitive, causing a large trade deficit. The economy is riddled with inefficiencies and restrictive practices. For example, cruise ships are not allowed to take on new passengers at Greek ports, and the number of lorry licences is still the same as in 1990 even though GDP has doubled. Such restrictive practices are keeping transport costs too high. According to Yannis Stournaras of IOBE, a think-tank, it is cheaper to transport goods to Athens from Italy than from Thebes, just 32 miles away.

Greece is an exemplar of the flaws in the European welfare model. The state gets remorselessly bigger because political parties of the right and left have bought votes by providing supporters with jobs or subsidies. Antonis Kamaris of Levant Partners, an investment group, says the state must "remove benefits that have built up like a ship accumulates barnacles". Public-sector workers were mollycoddled with pay for 13 or 14 months per year and arcane allowances for things like firewood or carrying files between office floors.

Tax evasion is widespread. A report by the London School of Economics estimates that it reduced Greece's potential tax yield by 26%. It is normal to do deals under the table. On the birth of his baby daughter one parent was asked to hand over €2,500 in cash to the doctor, in exchange for a receipt for €1,500. The Greeks are attempting to tackle this issue. The austerity packages introduced over the past 12 months require higher earners to provide receipts for expenditure before they can qualify for their tax-free allowance.

Market discipline did not work in either country. Greece benefited from the implied credit upgrade provided by joining the euro zone. Iceland, with its high interest rates, got a boost from the "carry trade", with investors borrowing money in low-yielding currencies (eg, the yen) and buying high-yielding ones (eg, the krona). "It was a classic case of monetary boom and bust," says Thordur Palsson, a former chief economist at Kaupthing, a big Icelandic bank. "The money supply increased at 40% a year over a five-year period."

Both economies face fundamental difficulties. For Greece, being a member of the euro zone is now a hindrance rather than a help. Its costs are too high but it cannot devalue its currency, and trying to inflate its way out of its debt would, in effect, be impossible. Iceland, which is not a member of the European Union, has been able to devalue the krona, but that created a problem for individuals and companies which had borrowed in foreign currencies. Its banks had to be nationalised and domestic depositors were favoured over foreign creditors.

Both countries have had to call in outside help. The Icelanders have borrowed from the IMF, with their negotiations made more complex by a dispute with Britain and the Netherlands over compensation for foreign depositors in one of its big banks. Iceland is trying to reduce its fiscal deficit, which in 2008 reached 13.6% of GDP, via increases in value-added tax, income tax, and petrol and alcohol duties. Rising unemployment has prompted many Icelanders to emigrate, causing the population to fall for the first time since the 19th century.

In Greece spiralling debt costs also forced the government to turn to the IMF as well as to its EU partners. But it remains to be seen whether the population will tolerate the austerity needed to bring the debt burden down to a reasonable level. The most recent package of cuts provoked a wave of strikes and riots in which three bank employees died.

America also faces a huge debt problem. The Congressional Budget Office calculates that the federal government will accumulate a deficit of $10 trillion between 2011 and 2020, and even that depends on some fairly optimistic assumptions about economic growth. Unless policies are changed, total government debt will reach 100% of GDP by 2023. There are unfunded liabilities on top of that. Chris Watling of Longview Economics reckons that the net present value of spending commitments under the Medicare, Medicaid and Social Security programmes is 276% of GDP. The Democrats resist cuts in entitlements and the Republicans resist tax increases, so nothing much gets done. Efforts to establish a bipartisan deficit-cutting commission have failed.

Advantage America

But America has two huge advantages over other countries that have allowed it to face its debt with relative equanimity: possessing both the world’s reserve currency and its most liquid asset market, in Treasury bonds. Even in the midst of the credit crunch, when some of the biggest Wall Street banks were collapsing, the dollar rose and Treasury bond yields fell, making it easier and cheaper for America to finance its deficit. There may come a time when America is hit by a funding crisis, but it does not look imminent.

America would be more at risk if the Asian central banks and sovereign-wealth funds had an obvious alternative. But with Europe in the midst of its own debt crisis, the euro does not look like an appealing option. And there is simply not enough gold in the world to absorb a substantial portion of central-bank reserves. For the moment, the dollar is the one-eyed currency in the land of the blind.

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