SUBMISSION TO SENATE STIMULUS INQUIRY

Tony Makin

Professor of Economics

Griffith Business School

Griffith University

Gold Coast campus

Australia 4222

September 2009

SUBMISSION TO SENATE STIMULUS INQUIRY

CONTENTS

Flawed Fiscal Fundamentalism

by Tony Makin[1]

(previously published in Kirchner, S. (ed) *Fiscal Fallacies*, Centre for Independent Studies, St Leonards)

Introduction

Australia is experiencing one of the largest fiscal turnarounds in its economic history based on the premise that governments can expand aggregate demand to counter a financial crisis induced recession. Nothing better exemplifies the resurrection of Keynesianism than the level of support it has received amongst policymakers, business leaders, unions, and commentators. It also demonstrates that a little knowledge, especially of macroeconomics, can be a dangerous thing.

Tens of billions of dollars worth of direct public spending, tax bonuses, and temporary welfare payments have been announced by the federal government since the 2007–08 budget. Along with the effects of the cyclical downturn itself on government revenue and outlays, this has transformed an estimated federal budget surplus of around 2 percent of GDP into a deficit of the same magnitude. With further fiscal deficits expected in the years ahead, it also ensures the federal government will re-emerge as a significant net borrower in financial markets for some time, requiring some $200 billion in coming years.

What we are now witnessing on the federal fiscal front is nothing short of an embrace of flawed fiscal fundamentalism. Like other forms of fundamentalism, unreconstructed Keynesianism relies on a literal interpretation of an obscure text written long ago when circumstances and institutions were quite different. The text in question is Keynes' *General Theory of Employment Interest and Money*,[i] published in the economically unenlightened 1930s—a time when monetary policy and independent central banks as we now know them did not exist.

The simple idea that by pumping up total spending, government can supplement depressed private spending and temporarily boost economic activity has appealed to economists and governments since the Great Depression of the 1930s. However, the following discussion suggests that the policy language used to describe changes in the stance of fiscal policy is tendentious at best and grossly misleading at worst.[ii] Indeed, there is as much a case for calling some forms of fiscal expansion, especially unproductive public spending, fiscal 'repression' rather than fiscal 'stimulus.'

---

[1]**Tony Makin** is Professor of Economics at Griffith University, Gold Coast campus, and a former Australian Treasury and IMF economist.

Counterarguments to fiscal activism

In its most basic form, Keynesian fundamentalism is founded on the now-redundant assumption that economies are closed to international trade and investment. But globalisation has greatly altered how fiscal policy works. These days, we cannot properly understand macroeconomic behaviour without taking account of foreign capital flows, exports, imports, exchange rates, and international competitiveness—variables that Keynes ignored in his original work.

First-year economics students are asked to believe in the Keynesian fantasy that extra domestic expenditure is the wellspring of even more additional output, though for those who continue their economics studies it is usually countered in intermediate level macroeconomics by exposure to theories, such as the Mundell-Fleming model,[iii] that show fiscal activism can be completely ineffective as a stabilisation tool.

The original Keynesian theory only works if you pretend the economy is completely isolated from the world economy. Only under the assumption of a closed economy would extra public spending fall entirely on domestically produced goods and services. And this occurs only if there is no offsetting behaviour by households and firms due to the additional demand for financial resources implied by the associated rise in borrowing and public indebtedness.

Yet in reality, extra aggregate spending for given national production widens the trade deficit, mainly via spending on imports, but also via spending on goods and services that would otherwise have been exported. This additional spending has to be funded by additional capital inflow from abroad, with little effect on domestic production and jobs.

Private investment also falls to offset extra debt-funded public spending because interest rates increase when governments start borrowing more. Future downgrades to the creditworthiness of state and federal governments by international credit rating agencies will add further to borrowing costs and become more likely the greater the public sector's borrowing requirement becomes. To the extent that the extra borrowing is sourced from abroad at higher cost in the present financial environment, this means the future stock of capital is lower than otherwise.

There is a glaring paradox about the use of discretionary fiscal measures and deficit financing to offset the effects of the global economic downturn. While the credit crunch and overall shortage of funds have primarily caused a downturn in real sector activity, for some reason governments around the world foresee no problems borrowing funds to cover their worsening fiscal deficits. Yet, extra government borrowing can only exacerbate the global funds shortage, pushing up long-term global interest rates.

This paradox is even starker for the United States, which started the crisis with a huge budget deficit, arguably a prime cause of the crisis in the first place because the

US budget deficit contributed to unsustainable expenditure in excess of US domestic production. Yet the United States will now need to borrow even more to facilitate President Barack Obama's proposed stimulus package.

As modelled more formally in Makin,[iv] higher government consumption lowers national saving, weakens the external position, and contracts national income. An easier fiscal stance resulting from higher public consumption spending, therefore, proves counterproductive as a means of boosting national income. On the other hand, public spending on highly productive infrastructure can raise national income, provided its rate of return exceeds the servicing cost of the borrowing required to fund it.

But if the extra government spending fails to generate an economic return sufficient to cover the servicing costs of the foreign borrowing, the seeds are sown for a future currency crisis. Such crises become self-fulfilling whenever foreign lenders suddenly cease lending on the expectation of future currency depreciations.

Lastly, the Ricardian Equivalence proposition implies that household consumption immediately contracts to offset fiscal expansion because households realise that higher taxes will be necessary in the future to repay public debt. There is ample international evidence that this occurs, at least partially, in advanced economies.[v] Taken together, the above linkages seriously caution against using large-scale fiscal activism as a supplement to monetary policy.

The international evidence

In surveying the empirical literature on the effectiveness of fiscal activism, the IMF itself in last year's *World Economic Outlook* stated:

> Perhaps surprisingly, the empirical literature on the effects of fiscal policy does not provide a clear answer to the simple question of whether discretionary fiscal policy can successfully stimulate the economy during downturns.[vi]

There is no conclusive evidence that activist fiscal policy aimed at changing the course of the short-term business cycle has ever worked to the longer term benefit of any economy. Many studies supportive of fiscal stimulus simply reflect their starting assumptions, including the questionable Keynesian premise that increased spending automatically increases output and employment.

Separating out the automatic changes in the fiscal position from the discretionary ones is difficult, and it is impossible to assess the counterfactual of how the economy would have performed had there been no fiscal response. Empirically, it is also difficult to disentangle the effects of fiscal stimulus from the effects of monetary policy easing that often occurs simultaneously. Estimating the economy-wide effects of fiscal stimulus is further complicated by the fact that earlier monetary easing has lagged effects of up to 18 months on economic activity.

There is nonetheless a sizeable international literature on fiscal multipliers. If extra fiscally induced domestic spending raises national output, multipliers are positive, and fiscal stimulus is effective. If multipliers are negative due to crowding out effects, 'fiscal stimulus' is a misnomer as it subtracts from output expansion.

While some studies yield positive fiscal multipliers in support of the Keynesian paradigm, including earlier academic work by the IMF's Chief Economist, Olivier Blanchard,[vii] there are many other academic studies that suggest the opposite.[viii] The IMF has been careful to qualify a call for fiscal stimulus with the proviso that it would not suit all countries and that debt sustainability may be a problem for some.[ix] For instance, IMF Managing Director Dominique Strauss-Kahn[x] stated:

> Of course, not every country can undertake fiscal stimulus. Some countries—both emerging and advanced—cannot finance higher deficits without risk to their creditworthiness. Some will need to contract their budgets rather than expand them.

We could read into this proviso that large international borrowers in the current climate should take special care. Selectively quoting the views of individual IMF staff as justification for fiscal largesse, as many presently do, is not the full story.

What has been ignored in current debate is that fiscal contraction that targets wasteful government programs improves macroeconomic performance. Numerous empirical studies,[xi] some undertaken at the IMF, support this. In essence these studies imply that cutting wasteful public spending programs 'crowds-in' private investment and this increases national income.

Such improvement occurs through lower interest rates, accelerated real investment and national income, as well as stronger exchange rates and external positions. This directly contradicts the Keynesian notion that fiscal policy is an effective counter-cyclical instrument. However, results critically depend on whether reduced government spending is in the nature of consumption or investment.

Australia's fiscal experience: Some inconvenient truths

The acceptance of Keynesian ideas last reached its peak in the 1970s when fiscal policy was deemed superior to monetary policy as a means of manipulating total spending in the economy. Budgets were explicitly framed to address the short-term business cycle, and fiscal deficits and significant public indebtedness were the norm.

Back then monetary policy played a more accommodating role, and inflation targeting and the notion of central bank independence were unheard of in most economies. Not coincidentally, the 1970s was the most abysmal decade for OECD economies, including Australia, in the post-war era according to a series of macroeconomic indicators that include economic growth, inflation, unemployment, and stock market prices.

Since then the standard Keynesian view that fiscal expansion stabilises macroeconomic activity has continued to provide federal governments with a rationale for expansionary fiscal policy, for instance, in the early 1980s and early 1990s to counter recessions at those times. However, there is no evidence that fiscal activism effectively alleviated earlier economic downturns.

The key question is whether Australia really needs fiscal ‘stimulus’ in the form of budgetary outlays when monetary policy is best placed to influence short-run macroeconomic activity. Since the onset of the global financial crisis official interest rate has been cut substantially, allowing the exchange rate to depreciate to boost Australia’s competitiveness.

Rationales for fiscal stimulus ignore the fact that Australia is an economy that is, and always has been, heavily reliant on foreign borrowing. Foreign borrowing, channelled mainly through the banking sector, bridges the gap between the nation’s investment needs, including for housing, and its own saving level.

It is Australia’s status as an international borrower, much laboured in past economic policy debate but now seemingly forgotten, that suggests there are serious risks associated with fiscal ‘stimulus,’ particularly if the stimulus comes in the form of increased government spending that ultimately proves unproductive.

For instance, subsequent to the fiscal expansion of the early 1980s there was a currency crisis in 1985 and subsequent downgrade of Australia’s creditworthiness by international credit rating agencies —evidence that the dollar depreciates precipitously and creditworthiness deteriorates when the rest of the world disapproves of Australia’s public spending habits. The irony is that confidence in the economy was then best restored by subsequent re-tightening of fiscal policy. In this way, past budget surpluses provided a measure of macroeconomic security.

The size of the public sector in Australia and other advanced economies has grown extensively with government spending in the OECD region as a whole rising from around 25 percent of GDP in 1960 to more than 40 percent today. A reason for this is that governments have increased public spending during economic downturns, but not fully reversed it during upswings.[xii]

This is not to deny that fiscal policy can improve the quality of public investment, including in human capital, and play a growth enhancing role. For instance, there is some evidence to suggest that improving returns from public investment through education and infrastructure can raise overall productivity.

Macroeconomic policy management

Since the early 1990s, short-run macroeconomic management had been assigned to the Reserve Bank of Australia (RBA) to conduct monetary policy at arm’s length from government, its main objective being inflation control. With the radical re-casting of fiscal policy as a short-run macroeconomic stabilisation tool, there are now two separate federal authorities responsible for national macroeconomic management: the RBA and the federal Treasury acting on behalf of the government.

The assignment of fiscal policy to longer term goals was not long ago widely accepted because monetary policy was on both theoretical and operational grounds thought to be more capable of influencing the economy in the short run. In particular, monetary policy was less handicapped by so-called implementation lags and the difficulties of reversing new public spending initiatives after the business cycle swings up.

Under previous arrangements, the fact that only one macroeconomic policy authority, the RBA, sought to stabilise the economy in the short term and obviate conflict in official circles regarding where the economy was headed. Under current circumstances, if both the RBA and Treasury try to steer short-run activity, yet cannot agree on basic macroeconomic forecasts, as is often the case, it follows they will have contradictory views about policy settings.

Cooler national policy responses to the global financial crisis have prevailed in comparable countries such as New Zealand, which is doing relatively less on the public spending front, but is no less exposed to the external financial crisis than Australia. The lesson to be learned from New Zealand in particular is that the aggregate supply side of the economy should also be receiving urgent attention to directly assist the business sector—the ultimate source of production in any economy.

One can also wonder what would have happened to the Australian economy had fiscal packages of recent magnitude been drafted in response to the 1997–98 Asian crisis. At that time there was no big fiscal policy shift. Monetary policy and the exchange rate entirely bore the pressure of the economy's adjustment to the external shock, and, as it turned out, bore this pressure most successfully.

If other major economies do pump prime their economies despite previous tearful endings, it may well be that the optimal response here is to be quite fiscally inert. This is because fiscal expansion in major trading partners will spill heavily over into their demand for imports. This would increase our exports and boost aggregate demand without Treasury moving a single dollar closer to raising public debt.

Past episodes of fiscal consolidation, as rare as they have been over the past half century in Australia, appear to have stimulated economic activity. Two examples that spring to mind are Treasurer Keating's budgets of the late 1980s and Treasurer Costello's 1996–97 budget.

In both instances, stronger than expected growth followed fiscal consolidation achieved by posting budget surpluses on the back of spending cuts. In contrast, there is no evidence that fiscal largesse and the big federal deficits that run during recessionary periods actually smoothed the path to recovery.

The fact remains, however, that consumption of all levels of government now stands at more than 18 percent of GDP, compared to around 12 percent in the early 1970s. Public investment has always been relatively smaller, and now stands at around 3 percent of GDP. Ample scope therefore exists for cutting government consumption as a means of bolstering the economy.

Concluding Comments

Fiscal activism has been largely discredited over recent decades because extra government spending proved to be less effective in influencing the economy than once thought. Keynes' original 1930s advocacy of public spending as a stabilisation tool was set against the background of the Great Depression, double-digit unemployment, and a persistently falling price level. Yet numerous economists have, for various reasons, denied that fiscal expansion assisted the US recovery from the Depression or helped Japan during its 'lost decade' of the 1990s.[xiii]

In the end, extra government outlays can only generate sustained national output increases if they involve or encourage productive, not unproductive, new expenditure. This is a major lesson of the global financial crisis, a major cause of which was the rest of the world's unwillingness to fund the US budget deficit and its runaway housing industry. Excessive public sector borrowing risks downgrades to Australia's international creditworthiness and an exchange rate crisis, which would be a repeat of the economy's experience in the mid-1980s.

This is not to say that more public infrastructure is not needed. However, infrastructure assists supply side capacity and has lasting benefits provided it is sufficiently productive. For this reason, it should be afforded priority over public consumption aimed at short-run demand stabilisation, the efficacy of which is highly dubious.

A tragic consequence of Keynes' contribution to economics was that for decades before it came to be discredited, most notably from the 1960s to the 1990s, it shifted attention away from the supply side of the economy, where output is first determined, to the demand side.

Keynes famously wrote more than 70 years ago: 'Practical men who believe themselves to be quite exempt from any intellectual influences are usually the slaves of some defunct economist.' These days, the 'practical men' are policymakers, commentators and bank economists, it seems.

As I have suggested previously, Keynes himself, whose relevance, properly interpreted, was for a different time and quite different circumstances, is now that defunct economist, though obviously still far from being recognised as such in policy circles. Present debate on fiscal activism is driven more by pure politics than rational economic analysis.

Endnotes

---

[i] John M Keynes, *The General Theory of Employment, Interest and Money* (Houndsmills, UK: Macmilllan, 1936).

[ii] This discussion expands on a presentation at the CIS Crisis Commentary on 3 February 2009 and articles written for the *Australian Financial Review*, "The Fiscal

Splurge We Don't Have to Have" 21 October, 2008, "Beware the Spending Spree" 15 December, 2008, and "Rudd Borrows from Tomorrow" 4 February, 2009.

[iii] RA Mundell, 'Capital Mobility and Stabilization Policy Under Fixed and Flexible Exchange Rates,' *Canadian Journal of Economics and Political Science* 29:4 (November 1963), 475–85 and J Marcus Fleming, 'Domestic Financial Policies Under Fixed and Under Floating Exchange Rates,' *IMF Staff Papers* 9:3 (1962), 369–379.

[iv] Tony Makin, 'Re-examining the Effectiveness of Stabilisation Policy,' *Australian Economic Papers* 46:4 (2007), 348–359. 'The Current Account, Fiscal Policy and Medium Run Income Determination,' *Contemporary Economic Policy* 22:3 (2004), 309–317.

[v] See Robert J Barro, 'The Ricardian Approach to Budget Deficits,' *Journal of Economic Perspectives* 3:2 (Spring 1989), 37–54; and Richard Hemming, Michael Kell, Selma Mahfouz, 'The Effectiveness of Fiscal Policy in Stimulating Economic Activity: A Review of the Literature,' IMF Working Paper 02/208 (Washington, DC: IMF, 2002).

[vi] International Monetary Fund, *World Economic Outlook* (Washington, DC: IMF, 2008), 164.

[vii] Olivier Blanchard and Roberto Perotti, 'An Empirical Characterization of the Dynamic Effects of Changes in Government Deficit and Taxes on Output,' *Quarterly Journal of Economics* 117:4 (2002), 1329–1368.

[viii] See Alan Auerbach, 'Is There a Role for Discretionary Fiscal Policy?' *NBER Working Paper 9306*, National Bureau of Economic Research (October 2002) and Signe Krogstrup, 'Should We Pay Attention to Indicators of Fiscal Impact on Demand?' HEI Working Paper 01 (Geneva: Graduate Institute of International Affairs, 2002).

[ix] Antonio Spilimbergo, Steve Symansky, Olivier Blanchard, and Carlo Cottarelli, *Fiscal Policy for the Crisis*, International Monetary Fund, SPN/08/01 (December 2008).

[x] Dominique Strauss-Kahn, Speech to the 44th SEACEN Governors Conference, Kuala Lumpur, Malaysia (7 February 2009).

[xi] See for instance:

1. Alberto Alesina and Silvia Ardagna, 'Tales of Fiscal Adjustment,' *Economic Policy* 27 (1998), 489–545.
2. Francesco Giavazzi and Marco Pagano, 'Can Severe Fiscal Contractions Be Expansionary: Tales from Two Small European Economies' in Olivier J Blanchard and Stanley Fischer (eds) *NBER Macroeconomics Annual*, (Chicago: NBER, 1990).
3. Francesco Giavazzi, Tullio Jappelli, and Marco Pagano, 'Searching for Non-linear Effects of Fiscal Policy: Evidence from Industrial and Developing Countries,' *European Economic Review* 44 (2000), 1259–1289.
4. Sanjeev Gupta, Benedict Clements, Emanuele Baldacci and Carlos Mulas-Granados, 'Fiscal Policy, Expenditure Composition, and Growth in Low-Income Countries,' *Journal of International Money and Finance* 24:3 (2005), 441–463.

[xii] Tony Makin, 'When Contractionary Fiscal Policy is Expansionary,' *Agenda* 5:4 (1998), 419–426.

[xiii] International Monetary Fund, *World Economic Outlook* (Washington, DC: IMF, 2008).

FISCAL 'STIMULUS': AN INTERNATIONAL LOANABLE FUNDS CRITIQUE

Tony Makin

Professor of Economics

Griffith Business School, Griffith University

t.makin@griffith.edu.au

Forthcoming in *Agenda*

FISCAL ‘STIMULUS’: AN INTERNATIONAL LOANABLE FUNDS CRITIQUE

Introduction

Within the G20 set of economies, accounting for around eighty five percent of global production, the size of the fiscal expansion in response to the economic downturn has varied substantially from member to member. According to IMF (2009, p.38) estimates, the scale of Australia’s fiscal expansion ranks equal first along with the United States, the epicentre of the crisis itself, amongst G20 advanced economies when measured relative to GDP.

For the first time in almost two decades, federal policymakers have again assumed that fiscal expansion is an effective means of countering a slowdown in Australia’s economic activity, despite the lack of compelling empirical evidence. As the IMF (2008) concludes in a survey of the effectiveness of fiscal stimulus, the evidence is ambiguous, with estimates of the effects of fiscal policy on national output differing “… not merely in degree but in sign.” (p.164).[1]

Keynesian fiscal activism founded on this presumption has been challenged previously on numerous theoretical and practical grounds.[2] The Mundell (1963) – Fleming (1962) model of an open economy for example concludes that, even during recessions, fiscal policy is ineffective in raising aggregate demand with a floating exchange rate and highly mobile international capital because it ‘crowds out’ net exports. However, the Mundell-Fleming model fails to treat international capital

[1] For instance, Blanchard and Perotti (2002) provide supportive empirical evidence, contrary to Auerbach (2002).

[2] See Barro (2009), Fama (2009) and Taylor (2009).

flows as discrete phenomenon, related to discrepant domestic saving and investment behaviour.

The following analysis aims to improve conceptual understanding of the nexus between budget deficits and the real economy by outlining a different approach to crowding out that extends the loanable funds framework, as applied to advanced borrower economies, such as Australia, New Zealand and the United States. Critical to this extension is the assumption that borrower economies face a rising supply price of foreign capital, as would be expected under current international financial conditions, characterized by a general shortage of funds.

An alternative diagrammatic framework is first developed, and then used to analyse the effects of budget deficit-raising stimulus in the form of increased government spending. In preview, contrary to standard Keynesian analysis currently underpinning federal fiscal policy in Australia, which essentially proposes that fiscal stimulus confers macroeconomic benefits by boosting aggregate demand, this approach provides an alternative perspective highlighting the macroeconomic costs that stem from resultant budget deficits and borrowing.

Loanable Funds Analysis with Interest Parity

Since domestic saving, domestic investment and foreign lending, are functionally related to the real interest rate, it follows from national accounting relationships identities that

$$I(\overset{-}{r}) + BD = S_p(\overset{+}{r}) + L^*(\overset{+}{r}) \qquad (1)$$

where I is investment, BD is the budget deficit, S_p is private domestic saving, and L^* is foreign lending.

The signs above the real interest rate indicate the effect of a rise in rates on the variable before the parentheses. Written this way, the expression also shows that the total domestic demand for funds must equal the total supply of funds forthcoming from home and abroad, with the real interest rate playing the equilibrating role.

If international capital mobility is assumed to be perfect, as is usual in most open economy models including the Mundell – Fleming model, the domestic real interest rate, r, is simply determined by the foreign real interest rate, r^*. This assumes real interest parity always prevails, irrespective of the economy's external indebtedness (to be relaxed subsequently).

Relationship (1) underpins an extended international loanable funds framework for analyzing the effects of various forms of fiscal stimulus on net foreign borrowing and national income. Figure 1 depicts a simple benchmark version where, in initial equilibrium, the budget is balanced, private saving and investment (and hence the current account) are balanced, and the stock of net foreign debt is nil.

The vertical private saving schedule implies that the responsiveness of private saving to a rise in the domestic interest rate, for given national income and household consumption, is negligible, as presumed in conventional theories of consumption, such as the Keynesian, life cycle, and permanent income approaches.[3] Alternatively,

[3] See Keynes (1936), Modigliani (1986) and Friedman (1957) respectively.

this schedule could be drawn slightly upward sloping, reflecting some sensitivity of private saving to interest rate changes in line with limited empirical evidence on this relationship,[4] but this would have no significant bearing on the results.

On the demand side of the funds market, whenever domestic firms invest by purchasing new capital, the cost of which is approximated by the real domestic interest rate, r, the demand for funds decreases as the real interest rate rises, in accordance with neoclassical and Keynesian investment theory.[5]

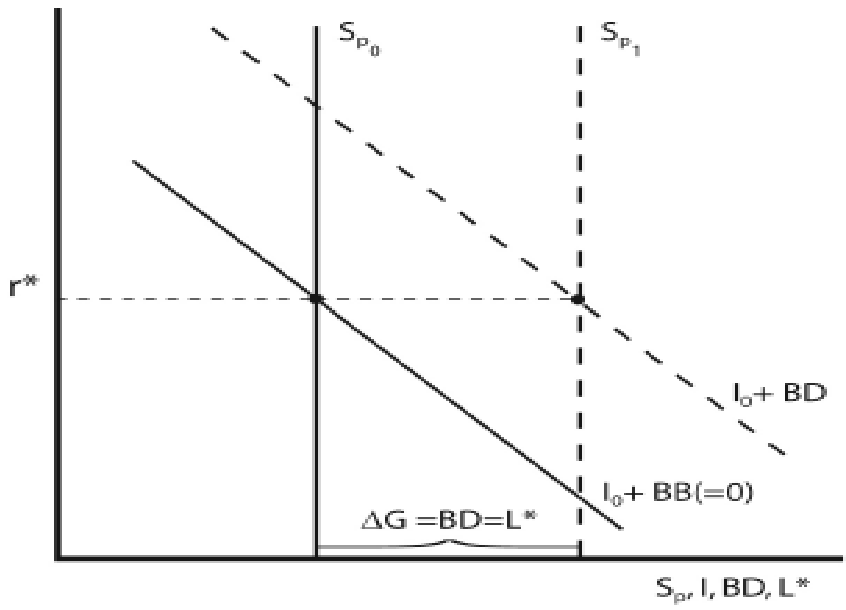

Figure 1 - Budget Deficits and the Flow of Funds

With regard to Figure 1, let us first assume that private investment increases which shifts the demand for funds schedule rightward. This extra investment adds to the

4 Masson, Bayoumi, and Hossein (1998) provide empirical evidence of a positive relationship between real interest rates and private saving in advanced economies.
5 See Romer (2005).

domestic capital stock and, consistent with neo-classical foreign investment theory,[6] enables extra production, or GDP, equivalent in Figure 1 to the sum of the upper triangular area and the rectangular area beneath it.

However, only the triangular area represents the net national income gain for the economy because the foreign borrowing to fund this investment has to be serviced at the prevailing world interest rate. Hence, the rectangular area, income paid abroad has to be subtracted from GDP. This result implies extra foreign-funded private investment should be welcomed on the grounds that it enhances macroeconomic welfare, despite the accompanying rise in foreign indebtedness. Such analysis has underpinned the argument that foreign debt incurred by the private sector in this way should not be a macroeconomic policy concern as it bolsters economic growth in net terms.

With fiscal stimulus, a move from budget balance to deficit increases the overall demand for funds, other things the same, and also shifts the total demand for funds schedule rightwards. If the supply of funds from abroad is perfectly elastic (the perfect capital mobility assumption), this increases net foreign borrowing to the same extent, suggesting that budget and external deficits are identically twinned.

Yet, fiscal measures which either increase public consumption directly, or represent spending on ‘social infrastructure’ projects that pay no rate of return (such as ‘free’ ceiling insulation for private dwellings) do not increase national output. Instead, budget deficits arising from such measures unambiguously reduce national income by

[6] See, for instance, Makin (2004).

the rectangular area, the servicing cost of additional net foreign borrowing required to fund them.

Loanable Funds with a Rising Supply Price of Foreign Funds

So far, real interest parity has been assumed. Yet, under current global financial conditions, characterised by risk aversion on the part of international lenders, it is unrealistic to assume the economy enjoys unlimited access to world capital markets. We should more sensibly assume that the supply price of foreign funds is rising, due for instance to a risk premium, ρ, increasing in the level of foreign debt, F. Moreover, the willingness of foreigners to lend to the economy shifts due to other forms of risk, ε, particularly the risk of future currency depreciation, such that

$$r = r^{*} + \rho(\overset{+}{F};\overset{+}{\varepsilon}) \qquad (2)$$

Accordingly, the economy is more likely to face an upward sloping supply of foreign funds[7], as shown by the L^{*} schedule in Figure 2.

[7] That Australia's long term bond rates have been persistently higher than comparable rates in the US and UK, and Japan, major sources of capital inflow, provides direct evidence of an interest risk premium.

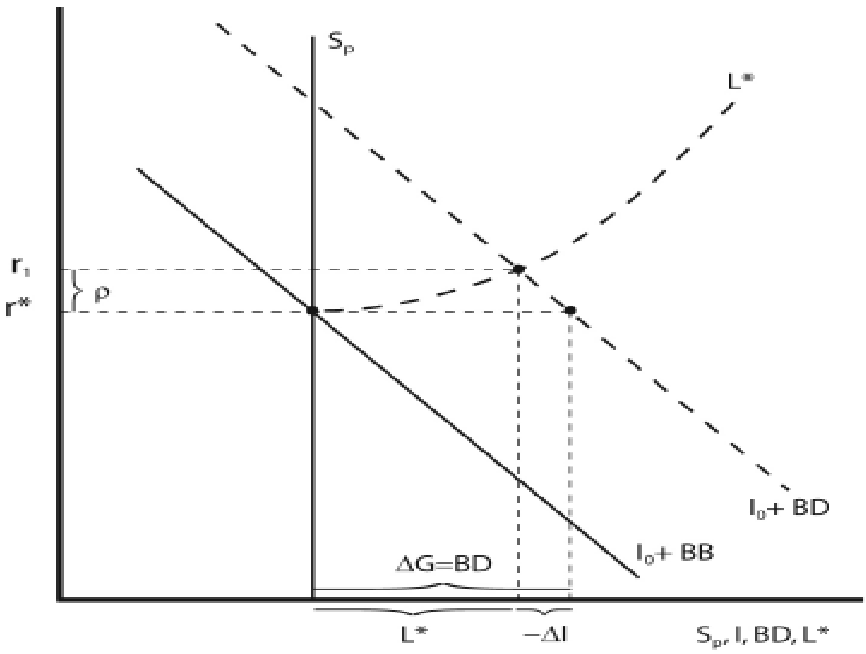

Figure 2 – Budget Deficits, Borrowing and Crowding Out

This more realistic extension of the standard loanable funds framework may now be used to reconsider the effects of fiscal stimulus on real interest rates, private investment and national income. To do this, it focuses on fiscal expansion in the form of higher public spending.

National Income Losses from Increased Government Spending

Higher government consumption immediately widens the budget deficit which must be financed. Hence, the total demand for funds schedule shifts right, creating excess demand at the prevailing real interest rate. This raises the economy's *ex ante* external financing requirement. At the same time, the debt–related risk premium rises, as foreign borrowing increases, other things the same.

In turn, this higher interest rate feeds back to crowd-out domestic private investment. Hence, unproductive public spending induced deficits are matched *ex post* by a combination of higher international borrowing and foregone private investment, as shown on the horizontal axis of Figure 2. This implies that budget and external deficits move in the same direction, but are no longer identically twinned.

Fiscal stimulus, either in the form of unproductive public spending or tax cuts and income transfers that lead to higher private consumption, confers both explicit and implicit national income losses. Income paid abroad is the explicit national income loss, and arises because additional borrowing has to be serviced at a higher equilibrium real interest rate following the fiscal expansion.

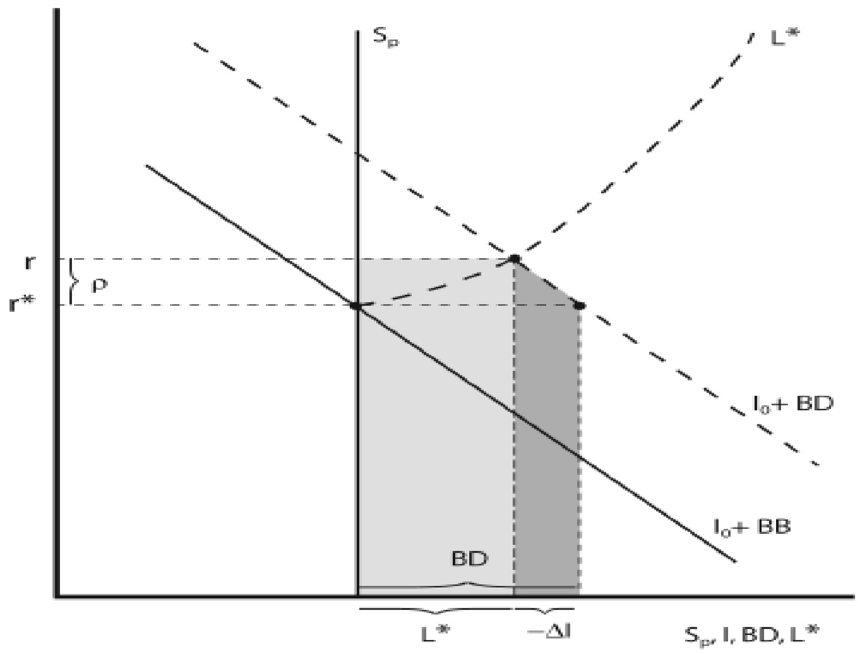

Figure 3 - Explicit and Implicit Costs of Fiscal 'Stimulus'

In Figure 3, this income loss resulting from the budget deficit (net of any private saving offset) is shown by the lighter shaded area. For an external borrower country, any fiscal expansion deemed effective in stimulating consumption entails this hitherto unrecognized cost. There is also an implicit national income loss. This is the national output foregone due to the loss of private investment crowded out by higher interest rates, indicated by the darker shaded area. Total national income lost due to consumption enhancing fiscal stimulus is the sum of the two shaded areas.

Conclusion

This paper has proposed an extended loanable funds framework for examining and interpreting the effects of fiscal stimulus on the budget balance, international borrowing, real interest rates, private saving, private investment and national income. It challenges the prevalent view that fiscal policy can be effectively used as an income stabilization instrument, and proposes that discretionary fiscal measures that increase the budget deficit entail macroeconomic costs for significant external borrower economies, such as Australia, New Zealand and the United States.

For an economy reliant on international borrowing, fiscal stimulus, especially in the form of unproductive government spending retards, not improves, national income growth by raising the cost of capital, and crowding out private investment. The corollary for public policy is that cutting wasteful public expenditure will lower the foreign borrowing requirement and real long term interest rates, thereby stimulating private investment and national income.

This is not to say that public spending on infrastructure can not positively influence national income in the same way as foreign-financed private investment does. However, additional public investment should be verified via rigorous project-by-project cost-benefit analysis and be as productive for the economy as the private investment it crowds out.

The above analysis presumes that the external borrowing and the matching current account imbalance are sustainable in the sense that foreign lenders remain willing to lend funds to satisfy fiscally-induced demand for funds. However, foreign lenders' perception of risk will change at some point if external finance is persistently used to fund unproductive spending, defined as that spending that fails to create the additional output needed to service loans into the future.

At such time, foreign lenders could expect the exchange rate to depreciate. The foreign lending schedule would then abruptly shift upward, pushing long term real interest rates even higher. This would further raise the servicing cost on existing and pre-existing foreign debt and crowd out more private investment, at greater cost to national income.

References

Auerbach, A. (2002) 'Is There a Role for Discretionary Fiscal Policy?' *NBER Working Paper 9306*, National Bureau of Economic Research, October.

Barro, R. (2009) "Demand Side Voodoo Economics," *The Economists' Voice* 6, 2, Article 5.

Barro, R. (1974) "Are Government Bonds Net Wealth?" *Journal of Political Economy*, 81, 1095-1117.

Blanchard, O. and Perotti R. (2002) 'An Empirical Characterization of the Dynamic Effects of Changes in Government Deficit and Taxes on Output,' *Quarterly Journal of Economics* 117:4, 1329–1368.

Fama, E. (2009) "Bailouts and Stimulus Plans" Available at www.dimensional.com/famafrench/2009/01/bailouts-and-stimulus-plans.html

Fleming, J. (1962) "Domestic Financial Policy Under Fixed and Floating Exchange Rates." *IMF Staff Papers*, 9(3): 369–79.

Friedman, M. (1957) *A Theory of the Consumption Function*, Princeton University Press, New Jersey.

Hemming, R, Kell, M and Mahfouz, S "The Effectiveness of Fiscal Policy in Stimulating Economic Activity" IMF Working Paper WP/02/208 and

International Monetary Fund (2009) *Global Economic Policies and Prospects*, Group of Twenty Meeting, March, IMF, Washington DC.

International Monetary Fund (2008) *World Economic Outlook*, September, IMF, Washington DC.

Keynes, J.M. (1936) *The General Theory of Employment, Interest and Money* Macmilllan, Houndsmills, UK.

Makin. A. (2004) *Global Finance and the Macroeconomy*, Palgrave Macmillan, Basingstoke.

Masson, Paul R. Bayoumi, Tamim A. Samiei, Hossein (1998) "International Evidence on the Determinants of Private Saving" *World Bank Economic Review* 12: 483 - 501.

Modigliani, F. (1986) "Life Cycle, Individual Thrift, and the Wealth of Nations" *American Economic Review* 76, June, 297-313.

Mundell, R. 1963. "Capital Mobility and Stabilization Policy Under Fixed and Flexible Exchange Rates." *Canadian Journal of Economics and Political Science*, 29(4):475–85.

Ricciutti, R "Assessing Ricardian Equivalence" *Journal of Economic Surveys* (17, 1, 2003).

Romer, D. (2005) *Advanced Macroeconomics*, McGraw Hill, New York.

Seater, J. 1993. "Ricardian Equivalence." *Journal of Economic Literature*, 31(1):

142–90.

Spilimbergo, A., Symansky, S., Blanchard, O., and Cottarelli, C. (2008) *Fiscal Policy for the Crtisis* International Monetary Fund, SPN/08/01, December.

Taylor, J. (2009) "The Lack of an Empirical Rationale for a Revival of Discretionary Fiscal Policy" Paper presented at the Annual Meeting of the American Economic Association, January. Available at www.stanford.edu/~johntayl/AEA_Paper_on_Fiscal_Policy_2009_JBT.pd

We keep repeating Keynes's mistakes

Tony Makin | August 26, 2009

SINCE the onset of the global financial crisis and the recession that followed, national economic debate, especially about the fiscal response to the downturn, has become unusually politicised.

A non-economist may justifiably ask why the debate about fiscal policy is so contentious. Ultimately, the answer to that depends on whether we accept or reject the more extreme ideas of the celebrated English economist, John Maynard Keynes (1883-1946).

Though dormant as an influence on macroeconomic policy for years leading up to the crisis, Keynesianism has unexpectedly reappeared centre stage as the sole theoretical rationale for fiscal stimulus. It should not come as a surprise that policies reflecting Keynes's ideas should provoke heated political debate.

After all, this is the same Keynes who in 1936, in the concluding chapter of his best-known work, The General Theory of Employment, Interest and Money, asserted, completely wrongly as it turned out, that in the post-Depression era "comprehensive socialisation of investment will prove the only means of securing an approximation to full employment".

And that: "The central controls necessary to ensure full employment will, of course, involve a large extension of the traditional roles of government." In the same chapter Keynes also wrote of the "cumulative oppressive power of the capitalist to exploit the scarcity value of capital".

Keynes's central planning approach to fiscal policy was credited by his disciples in the 1940s and 50s with saving Western capitalism from itself.

However, later critics of Keynesianism have argued that it was not fiscal expansion that ended the Depression, but that the Depression lasted much longer than it should have, especially in the US, because of a prolonged contraction of liquidity, policy-induced investment uncertainty, and large-scale retreat to international trade protectionism.

The enduring appeal of Keynes's theory was that it offered a cogent explanation of the main components of the national accounts and the phenomenon of the business cycle, while simultaneously asserting that governments could easily and at little cost correct macroeconomic misbehaviour at will and as it saw fit.

But this has always put Keynesianism at odds with the centuries-old tradition of economics that emphasised how prices automatically equilibrated markets and which suggested minimum government involvement in commercial exchange as the best means of allocating an economy's resources.

Such a way of thinking underpins, for instance, international trade theory and policy, which few question.

By asserting the opposite - that there was a greater need for government intervention in economic activity - Keynes's theory of fiscal activism introduced a logical inconsistency to economics that his critics have always found discomforting.

Keynes's general theory was anything but general in its original form and was premised on a special set of Depression conditions. These included interest rates at zero, ongoing deflation, and a prolonged collapse in international trade, none of which Australia presently suffers from.

The theory also ignored the fact that economies such as ours could be heavily reliant on foreign capital to fund its investment.

In short, Australia's present economic circumstances aren't like those Keynes sought to address.

It was left to another English economist, John Hicks, to make Keynes's theory more general in its application, while retaining its most useful elements such as his theory of consumption, investment and money demand.

Hicks's adaptation of Keynes's contribution, sanctioned by the man himself, synthesised the aggregate spending and monetary sides of an economy and for years was the mainstay of many textbooks. Yet, this framework actually shows that fiscal stimulus can quickly drive up interest rates, crowding out private investment to the longer term cost of the economy.

Another critical assumption of Keynes's 1936 work was that wages were inflexible downwards. While rigid wages were necessary to make Keynesian fiscal policy work in theory, this assumption is now less relevant in practice.

The prime purpose of fiscal stimulus has always been to preserve jobs. Yet, ironically, greater labour market flexibility than in previous recessions is doing that by itself.

Historically, Keynes's intellectual influence over policy-making reached its zenith overseas and here in the 70s, which was easily the single worst decade for economic performance in the Organisation for Economic Co-operation and Development region since the Depression.

That decade was characterised by Keynes's legacy of high budget deficits and high public debt, which in turn contributed to persistently high inflation, stagnant stock markets and high unemployment.

Recognising this, former British Labour prime minister James Callaghan declared in 1977: "We used to think we could spend our way out of recession. I tell you, in all candour, that that option no longer exists, and that if it ever did exist, it only worked by injecting bigger doses of inflation into the economy followed by higher levels of unemployment as the next step. That is the history of the past 20 years."

There is a strong chance that we are about to repeat that history because the so-called Great Recession has spawned what can only be termed the Great Fiscal Over-reaction, especially in Australia, the US and Britain, where faith in Keynes has always been most prevalent.

Thanks due to monetary policy

Tony Makin | July 14, 2009

Fiscal stimulus has had less effect than other measures.

IN most recent commentary on the state of the economy, it has become routine to credit federal fiscal stimulus, particularly the cash handouts to households, for any positive economic news. Whether it is the avoidance so far of a technical recession, higher than expected retail sales, or other miscellaneous measures of spending, we have been led to believe that things would have been much worse without the unprecedented fiscal activism.

But objective economic analysis based on standard textbook theory suggests that fiscal policy has played a significantly less important role in cushioning the impact of the global financial crisis on the economy as compared with the role played by monetary policy through interest rate reductions and associated exchange rate depreciation.

In other words, since the global financial crisis climaxed last October, dramatically easier monetary policy has probably done more for the Australian economy than fiscal policy. A less modest, or perhaps more independent, Reserve Bank would take more credit for this.

This can easily be explained with reference to standard macroeconomics textbook analysis. In an open economy, a major relaxation of monetary policy changes two key variables: short-term interest rates and consequently the Australian dollar exchange rate.

Consider interest rates first. The Reserve Bank reduced official interest rates by 4.25 per cent, from 7.25 in early September to the present 3 per cent, the lowest official rate for decades. Of course, not all of the interest rate cuts translated fully to home loan rates, but even if we compare, for example, a 3 per cent cut on a housing loan of $200,000, this implies extra household income of $6000 on an annual basis, a large multiple of the $990 cash handouts from the federal budget.

Official interest rate reductions have a much wider impact on the economy than on households with mortgages and other forms of debt. Importantly, they provide relief for private sector firms reliant on credit in constrained times. From an employment perspective, this is especially relevant, given that unemployment plagues the private not the public sector, especially small business.

Lower official interest rates also depreciate the exchange rate of the Australian dollar with additional stimulatory effects. Textbook analysis suggests that under floating exchange rates, a cut in short-term interest rates will discourage capital inflow, depreciate the exchange rate and improve competitiveness. This improved competitiveness manifests as a rise in exports and a fall in imports.

Many other things also influence the exchange rate besides interest rates, the most important being international commodity prices, reflecting the dollar's commodity currency status. Because of a combination of lower official interest rates and the initial slump in commodity prices in the wake of the global financial crisis, the trade weighted index value of the exchange rate fell by over 20 per cent between the beginning of the September 2008 quarter and the end of the March 2009 quarter.

This depreciation, now partly reversed, mitigated the effects of falling global demand on exporters of goods and services and also alleviated cost pressures on domestic manufacturers that compete with foreign suppliers. It is therefore no surprise that a trade balance turnaround, not consumption spending, was mainly responsible for the positive March quarter GDP outcome.

What economics textbooks also tell us is that continued fiscal expansion will limit the extent to which interest rates can be lowered in the future. This is because extra fiscal activity raises the demand for funds, which pushes up long-term interest rates. Higher long-term interest rates are now evident as a result of increased public sector borrowing around the world, and will increasingly make it more difficult for the Reserve Bank to influence longer-term interest rates going forward.

The major rationale for implementing fiscal stimulus is that it is supposed to counter the loss of confidence that causes a sudden spending stop. Where this has occurred most is with private investment expenditure. Business investment is a key driver of the business cycle and its recovery is essential for a strong economic rebound. It remains the real black hole in Australia's national accounts, falling by nearly 5 per cent in real terms in the March quarter.

Yet there is a glaring contradiction in the argument espoused both here and abroad that extensive fiscal stimulus is necessary for building business confidence. This is because higher government spending, and the higher than necessary long-term interest rates that result, will be inimical to asset price recovery, private investment and the strength of future economic growth.

Having a lend of ourselves

Tony Makin | June 01, 2009

DEFICITS and debt will remain central to Australian economic policy debate well into the future, the legacy of the global recession and deliberate policy responses that have dramatically recoloured red federal and state budget bottom lines.

Many have expressed concern about the worth of stimulus spending and the strategy for restoring the public accounts to rights. But the debate continues to focus mainly on the budget deficit and associated public debt increase.

Much less has been said about the implications for Australia's external (or current account) deficit, and foreign debt, which was an over-riding concern of federal economic policy during the 1980s and '90s. A long debate ensued in academic and policy circles on this issue during this time.

Two polar views about the significance of Australia's foreign debt emerged. One was that escalating foreign debt was a financial crisis-in-waiting and that policymakers should use all instruments at their disposal, notably restrictive fiscal and monetary policy, to minimise borrowing from abroad. Foreign debt was obviously inherently "bad".

The other was that external deficits and debt should not be a target of economic policy because they essentially reflected commercial decisions by private firms and financial institutions, which should be expected to act in their and the economy's best interests. If not, they go bust, at no cost to taxpayers. To avoid that possibility, it was also in foreign lenders' interests to ensure their loaned funds were used productively.

As an initiator and contributor to that debate, I long advocated the view that foreign debt incurred by the private sector was mostly "good". This was contrary to the other polar view whose adherents included a former employer, the Australian Treasury (where my opposing view first formed), the Reserve Bank, and both sides of politics, at different times and as circumstances suited.

Earlier research of mine showed empirically that foreign funds, overwhelmingly borrowed by the private sector, contributed positively to Australia's economic growth, and by implication helped Australia achieve growth rates above the post-war, long-term average of 3 per cent.

Past foreign borrowing funded higher rates of productive investment than would otherwise have occurred and was also more than matched by rising domestic asset values, thereby raising national wealth.

This interpretation of current account deficits and foreign debt evidently proved persuasive, as the issue has all but disappeared from public policy debate in recent years. But in light of present and prospective global financial conditions, the view that future foreign debt increases will necessarily be benign needs qualifying.

The case for interpreting foreign debt positively was founded on several important conditions that are likely to be violated.

One is that foreign borrowing is predominantly undertaken by the private sector for productive purposes. But this only follows in net terms if the federal budget is in surplus or in relatively small deficit.

A second condition for interpreting foreign debt positively is that foreign funds are freely available and continue to be provided on reasonable terms. However, in the context of a global credit crunch, this is no longer true.

With governments across the world running bigger budget deficits and borrowing more, long-term interest rates should continue to head upwards, as world recovery slowly gathers pace. This will increase servicing costs on Australia's existing foreign loans and make unviable foreign-funded projects with rates of return only marginally above the foreign debt servicing cost.

Given the economy's limited pool of domestic saving, borrowing abroad to fund future budget deficits is unavoidable. This makes comparison with public debt levels in other Organisation for Economic Co-operation and Development economies, expressed as a proportion of gross domestic product somewhat irrelevant, for none, except the US and New Zealand, has been as heavily reliant on global finance during recent decades.

It used to be a tenet of Keynesian economics, now back in vogue retro-style, that public debt was not a problem because "we owed public debt to ourselves". Neglecting that future generations have to pay it back, it meant that governments could run up public debt, without worrying unduly because its citizens and local financial institutions within the economy earned interest on it.

But this is not the case for large external borrower economies. Public debt that doubles as foreign debt precisely reduces national income by the interest payable abroad.

If too much of Australia's public debt funds consumption or fails to generate a sufficient rate of return to the economy, the risk rises that foreign lenders will start to see escalating public debt, not only as bad, but ugly as well. This would have serious consequences for the nation's creditworthiness, interest rates, and future economic growth.

Shoring up the IMF is best bet

Tony Makin | April 29, 2009

IN a victory for multilateralism, the most significant initiatives of recent Group of 20 meetings on the global financial crisis involve plans to renovate the international financial architecture, most notably by buttressing the role of a reformed International Monetary Fund.

The IMF -- which, it has been said, would have to be invented if it did not already exist -- is supposed to receive the lion's share of new funding ($US750 billion, or $1.07 trillion), mainly as contingent loans, in keeping with its role as the international lender of last resort at times of financial crisis.

Multilateral development banks areexpected to raise a further $US250billion to support international trade finance.

The IMF, along with the World Bank, has 185 member countries, at last count, a large multiple of the countries with a direct say at the G20 table. In principle, these funds could benefit the A to Z of the smaller economies outside the G20 grouping, from Albania to Zambia. Importantly, new funding to be at the IMF's disposal is not primarily aimed at financing new government spending and hence is not stimulus money as such. Instead the funds are intended mostly for emerging economies, heavily dependent on external finance, that are likeliest to suffer from a contraction of international capital flows.

Dependence on foreign capital is something Australia has in common with emerging economies and a sudden withdrawal of foreign funding remains the greatest risk to the Australian economy.

Since the onset of the financial crisis, frequent comparison has been made with the Depression, which spanned the economically disastrous 1930s. However, the real sectors of economies are quite a way from the depths reached back then, when economies such as those in Australia, Britain and the US experienced huge falls in production, deflation and unemployment rates ranging from 20per cent to 30 per cent.

The IMF was specifically established to prevent a repeat of the "beggar thy neighbour" exchange rate devaluations that prolonged the Depression. Under the Bretton Woods system of fixed exchange rates the IMF oversaw until it collapsed in 1971, the fund's key focus was restricted to exchange rate settings and international balance of payments problems.

Not coincidentally, exchange rates and external imbalances played an important, though much neglected, role in precipitating the present crisis, about which the IMF frequently had warned in the lead-up to it.

Before this crisis, East Asian central banks, by maintaining undervalued currencies, accumulated trillions of foreign exchange reserves, mostly US Treasury bonds, following the Asian banking and currency crisis of the late 1990s. Misaligned exchange rates and excessive accumulation of US dollar assets by East Asian central banks, mainly China's with $2 trillion worth, and the oil exporters occurred when the US was perceived as having deep financial markets and a stable banking system. This overvalued the US dollar exchange rate against East Asian currencies, which in turn overstimulated US consumption of cheap imports while assisting Asian export growth to the US and the rest of the world. Moreover, strong foreign demand for US debt instruments, much of it stemming from Asia, sustained unrealistically low US interest rates and credit that everyone expected would continue.

In this way, inflexible exchange rate policies implemented by Asian and oil exporting trading partners contributed to the US banking crisis.

Though it did not predict this crisis, the IMF had issued numerous prescient warnings about exchange rate misalignments, the US budget deficit and unsustainable global imbalances leading up to it. Through its regular surveillance and technical assistance activities, the IMF, post-Asian crisis, also put greater emphasis on ways of improving members' banking and financial sectors.

The problem is that the IMF can only advise, not insist, that members rectify bad economic and financial habits if countries have no need to borrow from it.

Australia, Britain and the US have fought against this crisis as if it were a war and, like World War I generals, have been sending taxpayers' money over the top, at a cost to future economic wellbeing.

The question that advocates of spend-on-anything fiscal stimulus, fiscal stimulists, still have to answer for economies such as ours, so heavily dependent on international borrowing, is this: Where is the extra money coming from to fund the hike in public spending?

China and Japan, recently large international lenders, also are running down their savings to fund fiscal stimulus packages of their own, which means their excess funds for lending abroad are shrinking fast. And China, with its already extensive holdings of US government bonds, is not keen to add further to its holdings because of the risks associated with US monetary and fiscal expansion continuing at its present pace.

Sustained national and global recovery will occur only when asset prices, including stock market and property values, exhibit sustained recovery. Ever more government spending and borrowing will not instil the confidence needed for that; quite the contrary.

Nonetheless, it is reassuring to know that the IMF will be better resourced to help Australia out should it continue down the path of fiscal excess and experience a fiscally induced crisis of its own.

Pocket money won't stimulate economy

Tony Makin | March 25, 2009

AUSTRALIA has so far followed the US fiscal expansionist response to the global financial crisis. However, unlike in the US, this radical fiscal turnaround has encountered minimal resistance from academic economists here.

In an open letter to President Barack Obama published in leading US newspapers earlier this year, hundreds of eminent US academic economists specialising in this field, including Nobel laureates James Buchanan and Edward Prescott, endorsed a statement that more government spending was not the way to improve US economic performance. Believing otherwise, they said, was "a triumph of hope over experience".

On both sides of the Pacific we have witnessed Keynesian fiscal responses motivated by fears of a repeat of the Depression of the 1930s. Yet as the US economists assert: "More government spending by Hoover and Roosevelt did not pull the US economy out of the Great Depression."

In other words, what could be called crank-handle Keynesianism, focused on government spending, did not even work when Model T Fords were around. So with suggestions that even more fiscal stimulus could be in the offing in the May budget, it is important to stress the drawbacks of misdirected policy, especially the cheque's-in-the-mail approach aimed at boosting aggregate household consumption.

Executing fiscal policy according to the motto "if at first you don't succeed, try again" is not advisable when that policy costs so much, is not evidence-based, diverts funds from more productive uses, adds to future interest rate pressures and risks the nation's international credit rating.

The economic consequences of giving money away to stimulate consumption can be illustrated by an exaggerated example. Instead of paying once-only bonuses to favoured groups who might spend their newly gotten gains, why not simply pay every schoolchild in the country a tuckshop bonus to be spent every day at their soon-to-be-refurbished schools. Every schoolchild could receive $5 - no, make that $10 - a day, paid directly from the federal budget. As the number of school students who attend class for 40 or so weeks a year is about 2.8million, this would amount to about $5.6 billion a year, more than half the first welfare-based stimulus package.

You may think such a bonus would surely boost spending in the economy, the key rationale for previously announced bonuses. To use old fashioned Keynesian terminology, school students should have a propensity to consume tuckshop items of about one. That is, every dollar given away would be spent at the tuckshop.

Much of this money would buy food and beverages made locally, but some would also be spent on imported tuckshop items, which would increase the trade deficit.

To the extent that the tuckshop money is spent on local produce it could also push up grocery prices for everyone. This would worsen inflation and competitiveness, indirectly contributing further to the trade deficit, which has to be funded from abroad.

When the temporary tuckshop bonus stops, the extra consumption spending in the economy would also stop. And if consumption spending and imports fell back to where they were before the bonus, we would be back to where we started. You may well ask: what was the point of it all? Were any extra people employed, and if so were they simply attracted away from other parts of the economy?

But that is not the end of the story because the tuckshop bonus has increased the federal budget deficit and the level of public debt. The budget deficit must be funded by borrowing money that could have been used for alternative, more productive purposes, such as infrastructure. At some point, this public debt also would have to be repaid. Assume then that the students receiving bonuses were told that an amount equivalent to the bonuses received, plus interest on that amount, would have to be repaid by someone in the future. They could therefore choose one of two courses of action.

The first choice would be to spend all the money as it came in and let someone else worry about paying higher taxes later. The problem with this option is that it would actually be them, the students, once they left school, or their parents and others who would pay the extra tax.

These higher taxes in the future would reduce the amount of disposable income available for future consumption, so that any stimulus the tuckshop bonus provided to total consumption now would lead to a subtraction later on.

This principle applies more widely. That is, any fiscal stimulus that actually works now must be matched by an opposite withdrawal in the future to reduce the budget deficit.

Smart, forward-looking kids could choose another option. They would realise that the tuckshop bonus meant higher future taxes after they left school, so they would save the bonus money for that purpose rather than spend it. Then they would be able to consume more in the future, unlike those who did not save their bonus money. If all school students (rationally) thought about the future consequences of the bonus, it would have no net impact on present consumption.

The classical British economist David Ricardo suggested this latter effect nearly two centuries ago in the context of debate about how Britain was to pay for its involvement in the Napoleonic wars. Revived more recently by Harvard economist Robert Barro, a strong fiscal stimulus sceptic, in one of the most cited papers in economics, it has become known as the Ricardian equivalence proposition.

In essence, it implies that household saving will rise following a fiscal stimulus, as of course it has. Everyone trained in macroeconomics learns about this proposition. Why federal policymakers have apparently ignored it remains a mystery.

Follow the Kiwi leader

In this crisis, our neighbour is a better economic model than the US or Britain, contends Tony Makin **|** March 11, 2009

DESPITE the federal fiscal stimuli we had to have, Australia is almost certain to experience the recession it was not supposed to have.

So, with earlier stimulatory measures failing to work as expected, what alternatives would work better?

The answer is: those primarily focused on the production rather than the spending side of the economy.

Federal fiscal packages unveiled since October last year have aimed to boost consumption in the short term, in keeping with Treasury advice at the outset that the best fiscal response to the global financial crisis was to "go early, go hard, go households". However, an arguably sounder fiscal response would have been the exact opposite: go later, go easy, go firms.

This does not mean federal policymakers should have ignored the downturn or that all aspects of fiscal stimulus packages have been unworthy. On the contrary, many infrastructure projects scheduled for future years have been overdue, there is some business tax relief and business regulation problems are being addressed.

But too much faith has been put in using fiscal policy to boost consumption on the demand side of the economy in the short run via tens of billions of dollars' worth of bonus payments. A different mix of measures should have recognised that the financial crisis first struck the aggregate supply side of the economy, not the demand side.

For federal fiscal policy to go later would have meant letting monetary policy go further in the first instance to pre-emptively manage the expected downturn in short-run macro-economic activity. The Reserve Bank of Australia has had much greater scope to do this compared with central banks abroad because official interest rates in Australia had been too high for too long before the global financial crisis hit home.

Inflation also had been wrongly diagnosed as an aggregate demand problem rather than a supply side, or cost-push, problem thanks to high oil and other international commodity prices.

The lowering of official interest rates by four full percentage points since September and the sharp exchange rate depreciation since then will do more to buffer the economy from the worst of the crisis than any fiscal action in train.

It also would have been advisable for federal fiscal policy to go easy in the light of the whack to budget revenue and the budget bottom line as a result of global commodity price falls and diminishing company and capital gains tax receipts.

Moreover, going easy on fiscal policy would have avoided the problem that will soon arise when government borrowing to fund growing state and federal budget deficits puts upward pressure on long-term interest rates, thereby limiting the Reserve Bank's discretion to lower interest rates across the spectrum.

"Go households" has meant channelling scarce federal fiscal outlays to select segments of the economy's household sector. But this has ignored the fact firms were the first victims of the crisis.

For many struggling firms, falling sales were initially less of a problem than the unavailability of credit. Paradoxically, the raft of hasty public spending initiatives implemented across the world may hold back recovery if households and markets become increasingly alarmed about higher future taxation, interest rates and inflation.

Unemployment is the scourge of recessions. However, it is the business sector, not households, that ultimately employs most people, creates most of gross domestic product and invests in the economy's future. Hence, it would have been better to assist firms' bottom line directly on the cost side through rapid regulation relief and tax relief, such as payroll tax reduction, than assist indirectly on the revenue side through trickle-down sales.

Though the federal fiscal response so far offers some business tax relief, this is dwarfed by the bonus payments aimed at boosting consumption.

Rather than following aggregate demand-oriented approaches adopted by the US, Britain and other countries, federal policymakers should look to New Zealand, which so far has avoided measures aimed directly at inflating consumption spending. Instead, the NZ Government has emphasised supply-side measures that will flatten marginal taxes levied on individuals, improve infrastructure and quickly lower the regulatory burden on business.

This is not the first time NZ has led the world in economic policy innovation. It was a Labour government there that initiated comprehensive economic reform under the direction of treasurer Roger Douglas from the mid-1980s.

This change in policy direction occurred following a currency crisis resulting from fiscal excess and included labour market reform, privatisation, public finance reform and trade liberalisation.

The breadth and depth of NZ's reforms had no precedent in the Organisation for Economic Co-operation and Development, and the measures were initiated before the Hawke-Keating government commendably followed suit with a similar reform program that delivered the strong productivity gains Australia enjoyed until the turn of the century.

NZ was also the first country to formally legislate for an independent central bank whose sole objective was to keep inflation low. Years later Australia adopted a weaker version of the NZ monetary policy model, as did Britain. It's now time to emulate the spirit of NZ's fiscal response to the crisis.

We all know about NZ's rugby prowess and how often it beats Australia at the game. If we were to score Australia v New Zealand on fiscal responses to the global financial crisis so far, it would be Australia0, NZ 1.

That's not counting penalty tries where one side gets points for being obstructed by the other. Such obstruction will be evident as public sector borrowing resulting from aggregate demand management by the state and federal governments in this country pushes up Australasian interest rates at NZ's expense.

Bad spend worse than no spend

A fiscal stimulus must boost productivity and cut wasteful spending, argues Tony Makin | March 04, 2009

WHENEVER the International Monetary Fund rushed to rescue a member country from financial crisis in the past, its standard diagnosis could be summed up using the organisation's acronym: It's Mostly Fiscal.

Accordingly, the IMF, one of the world's most effective post-war institutions, became renowned for prescribing fiscal austerity programs in response to financial crises, stressing the need to reduce high budget deficits and public debt levels. This fiscal contraction was best achieved via drastic public spending cuts, as well as lasting measures to improve tax systems and their administrative efficiency.

This line previously met strong criticism, especially from governments loath to take unpalatable medicine as a precondition for the IMF's lending hand. But to the IMF's lasting credit, it most often worked to the longer term benefit of many economies.

The latest message from the IMF in response to the global financial crisis appears to contradict this line. The IMF's managing director, Dominique Strauss-Kahn, and its chief economist, Olivier Blanchard, have not stressed the need for fiscal stringency, but fiscal expansion. They have, uncharacteristically for the fund, apparently endorsed Keynesian-oriented fiscal packages proposed worldwide.

The crisis has also revitalised the IMF, allowing it to reconfirm its indispensible role as the world's financial fire brigade and to raise more funding from governments into the bargain. Like liquidators, the IMF thrives at times like these.

However, few have noticed that the IMF has heavily qualified its call for fiscal expansion, with Strauss-Kahn stating last month at a meeting of Southeast Asian central bankers, that: "Of course, not every country can undertake fiscal stimulus. Some countries -- both emerging and advanced -- cannot finance higher deficits without risk to their creditworthiness. Some will need to contract their budgets rather than expand them."

Australia remains heavily reliant on foreign credit, as always, and in these tough and highly uncertain times, the possibility of a currency crisis and risk of a downgrade to the economy's creditworthiness cannot be ignored. Just ask the Queensland Government.

Under such circumstances, Strauss-Kahn's statement suggests Australia need not have followed the highly fiscal expansionist path it has adopted since October last year. A more restrained response would have remained consistent with his nuanced fiscal policy advice.

How then could fiscal expansion and fiscal contraction both be right? It's because what matters most is the quality of any change in the fiscal stance, not its quantity.

More productive public investment in human capital, and tax changes that improve incentives to work or induce greater private investment that creates or saves jobs, are all worthwhile. Unproductive public consumption, or measures that artificially boost private consumption as if the economy was just a giant hydraulic machine closed off from the rest of the world, are not.

The benefit of pumping up total spending by any means, like digging potholes for the sake of it, is a Keynesian delusion. Retail spending may be responsive to fiscal largesse, but the retail sector is not the economy. It's a relatively small part of it that sells many imported items. And how you disentangle the effects of huge interest rate falls and lower petrol prices on retail sales figures is anyone's guess.

Expansionary public spending in the form of public consumption actually reduces national income in the near term because it raises the economy's net foreign borrowing requirement, which must be serviced out of output.

In a 2007 published paper (Re-examining the Effectiveness of Stabilisation Policy), I proposed a macroeconomic model that shows government spending can only improve national output and income if it raises the economy's productive capacity. These findings are consistent with those of conventional growth theory, but apply in the medium term, not just the long term.

What has remained largely unrecognised in the present Australian debate is that fiscal consolidation that targets wasteful government programs actually bolsters macroeconomic performance. Numerous empirical studies, many published by the IMF, support this and contradict the Keynesian premise that public spending of any kind is always and everywhere an effective countercyclical measure.

These studies reveal that cutting wasteful public spending creates space for private investment and increases national income. This is because it increases domestic saving, reduces long-term interest rates and improves business confidence.

In short, a fiscal stimulus does not automatically generate sustained economic activity, especially following a boost in public consumption, the blunting of incentives to work and save or through poorly conceived infrastructure spending that generates a very low, or nil, rate of return.

On the contrary, cutting middle-class welfare is likely to be expansionary for the economy and should now be a top priority. Every dollar of spending that is cut will free up funds that are now in short supply. Preserving wasteful programs because cutting them would be contractionary is misguided thinking.

As part of his overly ambitious fiscal strategy, President Barack Obama's administration unveiled plans to cut spending programs. Despite different economic circumstances, Australia mimicked US demand-oriented fiscal strategies, some of which, like once-only bonus payments, did not work.

But announcing spending cuts as a means of restoring confidence is one fiscal initiative Australia has not followed. Given the prevailing economic uncertainty, such a strategy would be better announced now than in May's budget.

If any kind of public spending is acceptable because it somehow adds to total spending in the economy, we can only conclude, of federal fiscal policy, that It's Mostly Futile.

Tony Makin is professor of economics at Griffith University, and a former IMF economist.