

IS THE GLOBAL FISCAL CRISIS OVER?

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Have we seen the worst of the global fiscal crisis? The short answer is no. The big economies, with the exception of India and Germany, are continuing to have increasing debt-to-GDP ratios. As debt grows as a percentage of GDP, after some point, it has increasingly negative effects on real growth. Economists debate where the tipping point is, but the empirical evidence shows that as debt approaches a hundred percent or more of GDP, economic growth slows. Japan, Italy and Greece all have debt-to-GDP ratios well over 100 percent – over 200 percent of GDP in Japan's case – and all are plagued by stagnation or worse.

The growth in relative government spending in almost all countries is largely caused by growth in government pension and medical care programs and other forms of welfare. The political class in most countries has found it most difficult to cut back the growth in these programs because of rapidly aging populations. Japan, Italy, Greece and many other countries now have negative population growth. Fewer workers to support more retirees, along with their medical problems, is not sustainable in the long run. Real wages adjusted for inflation and taxes are now falling in many countries. How long before the workers revolt?

Traditionally, countries have escaped from unsustainable fiscal situations by inflating their currency – but inflation is a particularly cruel tax on poor and low-income people, and more often than not

eventually leads to the defeat of the political party in power. Many countries have sharply increased taxes in vain attempts to close fiscal gaps. The problem is that most countries have tax rates well above the growth and revenue maximizing levels, so increases in taxes result in lower growth and a worse longer-run fiscal situation. From the onset of the “Great Recession,” major central banks have been used to paper over the growing fiscal crisis by buying government debt and keeping interest rates near zero. This keeps apparent government spending as a percentage of GDP lower than it would be if the interest on government debt reflected a true market rate.

Governments have also greatly expanded financial and banking regulations in an attempt to collect more taxes and prevent future financial meltdowns. As Peter Wallison explains in an article in this issue, the increase in financial regulation is likely to make things worse, not better. He documents the series of blunders by both Federal Reserve and U.S. Treasury officials at the beginning of the 2008 financial crisis. Their mistakes were appalling, and there is absolutely no reason to believe that those now in similar positions will be any smarter or wiser when the next crisis hits – which it will, given that the necessary real corrective actions have not yet been taken.

In the same vein, Donald Schwarzkopf argues that the international rule of law is being undermined by governments that choose to renege on their sovereign debt. Argentina is, of course, the poster child for irresponsible fiscal and debt policies. As a condition of issuing its government bonds, Schwarzkopf notes: “Argentina voluntarily submitted itself to the jurisdiction and law of New York, and agreed to certain contractual terms in protecting its creditors.” The reason Argentina did that, of course, was to obtain lower cost loans than it could have if it had chosen to use the Argentine credit markets and courts. What is disturbing is that many economic journalists, economists and representatives of international financial institutions have argued for debt relief for Argentina, without thinking of the consequences of such a precedent. Fortunately for the rule of law, the New York courts have continued to uphold the creditors’ rights. Remember, the Argentine government was freely elected, and Argentina was not insolvent at the time of debt default – only partially illiquid. There is no reason that the creditors should suffer because of the poor choices made by the Argentine people and their elected leaders. If international bond contracts are not going to be enforced, the cost to the citizens of debtor countries in the future will be much higher.

Problems associated with government debt, financial regulations, demography and the undermining of the rule of law have not been lost on financial innovators around the world. Entrepreneurs have

seen the need for better and lower cost money transfer and payment systems. Increased financial regulation is costly for the banks and other institutions that are regulated, and these costs are passed on to their customers. The rise of Bitcoin and its new competitors is a market response to the cost and intrusiveness of government financial regulation. People want reasonable financial privacy, convenience, speed and low costs in their financial dealings.

In this issue, Norbert Michel and Scott Burns describe a number of projects now underway around the world to provide sound money and better payment systems outside those owned or controlled by governments. Government bureaucrats fear the loss of their monopoly on power that these new innovations might cause. As would be expected, in many places like China, Russia and even the state of New York, they are trying to ban or control them. One great success has been the rise of mobile phone-based payment and banking services in some of the countries in sub-Saharan Africa, such as Kenya. Likewise, there is a great deal of financial innovation taking place in Estonia because it is more open, as Meelis Kitsing explains in his article. Estonia was the first country to go to e-government and now allows foreign persons to establish e-companies. In cooperation with BitNation, Estonia now also offers e-notary services to its e-residents to address the needs for better governance services and to make it possible for virtual states and nation states to compete and collaborate.

Skype was created by two Estonians, and currently its development and engineering center is there. Two Estonians also have created TransferWise, a company that enables money transfers, including currency conversion between people outside the banking system by using a “peer-to-peer” business model. TransferWise is much less expensive and usually faster than bank wire transfers. More detail about TransferWise and Estonia can be found in Kitsing’s article.

In summary, most governments are not coming to grips with the ongoing fiscal crisis. They are engaged in short-term measures, which are likely to make the long-term situation worse. The new financial innovators who are trying to work around the increasingly destructive financial regulations will provide some relief, like the black marketeers did in the old Soviet Union and Eastern Europe. Their efforts can only slow the ongoing crisis until real solutions are addressed, including pension and medical entitlement reform, pro-growth economic policies and much more economic freedom, including financial freedom.

The situation is not hopeless. Countries faced with an ongoing crisis have made real reforms, and they only need to be emulated. The Chilean pension program created by Jose Pinera more than three decades ago, and now adopted by some 30 countries, has demonstrated that a country can have a sound pension system based on market returns, even with a slow or non-growing population. Many countries have proven that trade liberalization spurs economic growth and well being. Switzerland has shown that it is possible to put measures in place so that government does not grow faster than the economy.

The global fiscal crisis is not going away until leadership emerges in the U.S., Europe and Japan to make the necessary reforms. The good news is that this is all doable and that the period of pain during reform can be both short and not all that bad.

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