Fiscal plans will jump-start economies

In the second extract from his new book, **Gerard Lyons** sets out his essential rules for the new global economy

In the future, successful economies will be those that observe the following guidelines: adapt and change; play to strengths; and position effectively, either by making themselves an attractive place in which to invest or creating an enabling environment that makes them a hotbed for entrepreneurs.

Given the global macroeconomic outlook, the successful countries will have at least one of the three Cs: Cash, Commodities or Creativity. That is, the financial resources, the natural resources or the human ingenuity and skill to thrive, all aided by sensible economic policies.

Clear longer-term planning can work in an economy just as an overall strategy can succeed in a company. When there are clear and deliverable goals, the public and private sector can collaborate in an economy – the London Olympics was a classic example. But the main focus should be about creating the enabling environment to allow the private sector to deliver, free from government interference, to encourage innovation and entrepreneurs.

Within this whole story, fiscal policy poses one of the most important challenges in the eyes of the financial markets and international investors. They can either be spooked or reassured by fiscal plans.

There are 10 rules of fiscal policy that will matter in the future. The encouraging news is that many emerging economies look set to be following these rules; this should promote future growth.

Rule 1

Governments should run budget surpluses in good times. This is the most important rule of all. Tax revenue should exceed government spending. When it does, the government can view the surplus as money set aside for a rainy day, or use it to pay down the national debt, reducing future interest payments on it. If growth is strong and interest payable is low, then a government can afford to run small deficits.

But as there are so many variables, some of them beyond a country's control, it makes more sense to aim for budget surpluses and hope at worst to minimise any deficit. This is not the usual way that things are done. Instead, the temptation pulls in the other direction and governments spend when they can. Whereas the budget-surplus rule requires a government to think long-term, too often the habitat of politics is the short term.

When an economy is doing well, tax revenues rise and spending on discretionary areas such as benefits and the unemployed will fall. In fact the goal of running a primary surplus – which means having a surplus after paying off the interest on the debt – would be an even more effective outcome to aim for.

In life, as in economics, the best time to fix things is when they are going well, not when they are ailing. The trouble is that when things are going well, it is easy to assume that they always will and to put off confronting the difficult longer-term issues. In terms of fiscal policy, this is reflected in government spending. In Western Europe before the crisis, the governments in many countries spent their way from famine to feast and seemed to assume they could easily go on a diet to get back into shape. What was really required was a change in lifestyle, in the shape of fundamental reform.

Rule 2

If governments ignore Rule 1, and fail to run budget surpluses in good times, it means that they are already at a disadvantage if an economy either slips into recession or weakens. As an economy enters recession, people and firms avoid spending, which then puts further pressure on governments to act in a counter-cyclical way – spending when both the economy and demand are weak.

Of course, if governments have behaved badly in the good times, this limits the room for fiscal manoeuvre in the bad times. This has been the challenge in recent years. It can be summed up as two wrongs don't make a right: if the first wrong is spending too much in the good economic times, the second is failing to spend when the downturn arrives. A government budget is not exactly the same as a household budget and has a lot more flexibility. Clearly fiscal policy is not immune from overall economic conditions, and a fiscal expansion works best if there is weak demand, high unemployment, low inflation and low interest rates.

Rule 3

It is not just how much a government spends that should claim its attention, but also what it spends on. Quality matters as well as quantity. This is a rule too frequently ignored. Governments can take long-term decisions and in recessionary times can often raise money relatively cheaply from international investors. Current consumption comes second to infrastructure investment. Even if a country has a budget deficit, it could make sense to boost spending on longer-term needs, such as housing and highways, just as a person might borrow through a mortgage to fund a house purchase. Countries need to find a way to fast-track sensible infrastructure projects for this to be taken more seriously as a counter-cyclical tool. No one gets this right, with some taking too long while others rush ahead with projects that are not well thought through.

EPA/JIM HOLLANDER

The London Olympics is a fine example of when the public and private sectors collaborate because there are clear, deliverable goals

Rule 4

It is wise to stop before crashing. It is essential to know what lies ahead and to demonstrate that in the way the economy is driven. When budgets need restoring into shape, it is difficult to do this overnight: the call is for a credible medium-term plan to get a fiscal position back into shape, keep financial markets onside and borrowing costs down. Put the foot on the brake gradually.

Rule 5

If you are in a fiscal hole, stop digging. A pro-cyclical policy that tightens when the economy is in recession is credible neither in political nor in economic terms. It amounts to digging deeper into the hole, yet it has been the preferred policy choice across parts of Europe in recent years. Some politicians might argue that it is only in hard economic times that the public might put up with painful reforms, but all too often there may be no vision or context applied to what is happening. This puts all the pressure on monetary policy, which therefore needs to square with fiscal policy. Ideally they should work in the same direction, although often it might not be desirable to loosen or to tighten fiscal and monetary policy at the same time.

Rule 6

The speed and scale of tightening is a judgement call. It is only with hindsight that it can be said to have been either right or wrong. The phrase "expansionary fiscal contraction" has been used in recent years, meaning that a contraction in government spending can allow the economy to expand by crowding in private-sector spending.

This has happened before, such as in Denmark and Ireland in the 1980s, but it is not the norm, and requires the rest of the world to be growing, and there also needs to be an accommodating monetary policy to offset the tight fiscal policy. Sometimes a country will have no choice but to tighten its belt – because its debt is high and creditors demand action – and in those circumstances my view is that the right type of austerity is to curb government spending and the wrong type of austerity is to raise taxes.

Rule 7

Debts should always be considered alongside assets when a country's balance sheet is being drawn up. We tend not to consider these properly, and probably we should. In the banking crisis, the debts were socialised, which is not how it should have been, as the taxpayer was used to bail out the banks. A government should leave its fiscal position in good shape, both to cope with shocks, and so as not to place burdens on future generations.

Rule 8

Avoid a debt trap. This is familiar to anyone who has run up debts on a credit card. A debt trap provides less room for manoeuvre. It happens when two factors are in place: a country's debt outstrips its economy, which means that debt is more than 100pc of GDP; and the interest rate paid on debt is higher than the rate of economic growth. It is like maxing out on a credit card and not being able to pay the monthly interest bill. Just as an individual in that position has little room for manoeuvre and has to cut discretionary spending on other areas, so too a country that gets into a debt trap ends up having to curb spending.

Rule 9

Fiscal policy cannot be seen in isolation from monetary policy. Ideally there should be consistency between fiscal and monetary policy, working together when necessary. Fiscal policy should not impose unnecessary strains on monetary policy. One danger with high deficits and debts is this can lead to calls for the debt to be inflated away, through a tolerance of higher inflation. This is a dangerous path to go down. Likewise, in recent years, the strain has been seen with pressure on central banks in the West to pursue ultra-loose monetary policies.

In the UK during Chancellor Nigel Lawson's late-1980s boom and bust there was a misconception that a healthy fiscal position was bound to mean economic stability and that promoted a relaxed attitude about what lay ahead, with monetary policy then allowing a credit boom reflected in rising private-sector debt.

The thinking then, which I disagreed with at the time, was that the government should not worry about what the private sector did, as it was based on individual decisions. This has a certain political logic to it but in economic policy it is necessary to take greater responsibility for the collective actions of the private sector. After all, they can push the economy into trouble, and in a worst-case scenario private sector liabilities can end up as liabilities of the taxpayer.

Rule 10

Finally, one size does not fit all. This is true for fiscal policy as it is for monetary policy. It means the rules outlined above still hold but their effectiveness can vary across countries, depending not just on current economic conditions but also being heavily influenced by the past and by what people think is the right thing to do.

The Consolations of Economics: How We Will All Benefit from the New World Order by Gerard Lyons (Faber & Faber, rrp £16.99) is available for £14.99 plus £1.35 p&p from Telegraph Books Direct on 0844 871 1515 or at books.telegraph.co.uk.

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