Macroeconomic Impacts of Globalization

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With floating exchange rates, high capital mobility may render expansionary fiscal and monetary policy ineffective (or even counterproductive). … Internationalization will undermine the autonomy and efficiency of government macroeconomic policy. Milner and Keohane, 1996 p. 18

Introduction

Globalization has led to substantial changes to the economies of many nations. The contemporary form of globalization has substantially increased the degree of openness of most economies, both in terms of international capital flows and in trade and it represents an almost overwhelming force impacting on all countries. This paper considers some of the implications of the macroeconomic impact of globalization on nation states within an explicitly Keynesian/Kaleckian framework. Two interrelated forms of macroeconomic impact are considered. Initially, the general implications of globalization for the output and growth of national economies are examined, before turning to the constraints imposed on the ability of governments to influence the macroeconomy via traditional polices.

In terms of macroeconomic outcomes, a major impact of globalization is on the level of employment and output through the balance of trade. Increased openness increases reliance on international trade. This, of course, need not be, per se, a problem. Difficulties arise due to the lack of effective instruments to deal with balance of trade imbalances, particularly deficits. The implications of this lack of instruments is to establish a deflationary/contractionary bias in the international monetary system, with important implications for the growth of output and employment.

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The problem is exacerbated by the limitations on macroeconomic stabilization policy resulting from globalization. Many economists and policy analysts argue that globalization, particularly the increased mobility of international financial capital, has undermined the ability of countries to engage in independent macroeconomic policies, whether fiscal or monetary. The implications of this is that governments are less able to insulate their economies from the adverse effects of trade.

The next section outlines Keynes’ and Kalecki’s arguments that trade imbalances are the result of countries shifting their own unemployment problems elsewhere. High saving countries tend to have problems maintaining levels of domestic demand high enough to fully employ their workforce. Surpluses are a way of exporting unemployment to deficit countries. The international monetary system, by putting the onus of adjustment on the deficit country, introduces a deflationary bias to the international system, which has been reinforced by recent movements towards increased globalization.

Conventional neoclassical economics does not agree that trade imbalances are undesirable or place constraints on the domestic economy. According to this view, trade balances do not matter as surpluses, which are the result of high saving ratios, allow those savings to finance economic activity in low saving countries. The neoclassical arguments are briefly outlined in the section entitled ‘The neoclassical view of trade imbalances’ and the weaknesses in this position are pointed out.

Globalization reduces the ability of macroeconomic policy to stabilize the economy at an acceptable level of employment. The paper outlines the reasons for this, and their implications, in the case of both monetary policy and fiscal policy.

**Keynes and Kalecki on international trade and the payments system.**

International trade is a desperate expedient to maintain employment at home by forcing sales on foreign markets and restricting purchases, which, if successful, will
merely shift the problem of unemployment to the neighbour which is worsted in the struggle. Keynes, 1936 pp. 382-3

Within the Keynesian/Kaleckian framework, full employment is not the normal state of affairs in capitalist economies, with the main determinant of the level of output and employment being the level of effective demand. Within this framework, a higher saving ratio is likely to lead to lower growth rates and relatively higher levels of unemployment. This is due to the role of saving as a leakage, so that any attempt to increase saving (reduce consumption) will lead to a multiplied reduction in income (The Paradox of Thrift).

This leads to an association between high savings ratios and low levels of output and employment. One way for a nation to overcome this problem is to export unemployment. In other words, to overcome the domestic shortage of demand by substituting export demand for domestic demand. In this case, since one country’s surplus is another country’s deficit, the leaking of demand from the deficit country will reduce demand and employment there.

Keynes clearly understood the importance of international trade as a mechanism for exporting unemployment between developed nations (Keynes, 1936, ch. 16). According to Keynes, the primary condition for stability is the attainment and maintenance of full employment by means of domestic policies. If developed countries failed to use domestic policy to maintain full employment, then, to the extent which they could maintain a trade surplus, they can export unemployment problems to countries with resultant deficits. The international battle for markets was seen by Keynes as being a battle caused by countries abdicating their domestic responsibility to maintain full employment. He also warned of the dangers of such battles:

The fact that the advantage which our country gains from a favourable balance is liable to involve an equal disadvantage to some other country ... means not only that great moderation is necessary, so that a country secures for itself no [more]... than is fair and reasonable, but also that an immoderate policy may lead to senseless international competition for a favourable balance which injures all alike. Keynes, 1936 pp. 338-9

Keynes realized the importance of an international system of payments which would ensure such ‘reasonableness’. However, during the Bretton Woods conference, which developed the post
war payments system, his suggestions were not adopted (See Skidelsky, 2000 chapter 10). The resulting system, and its contemporary offspring have no mechanism to ensure ‘reasonableness’ and therefore contain the seeds of an international tendency towards stagnation.

According to Keynes the ability of countries to influence their balance of trade came mainly through influence on imports. He saw devaluation/depreciation as of limited efficacy in influencing trade. On the other hand, trade protection had political limitations, and was likely to lead to retaliation. So the main mechanism to improve the balance of trade was a reduction in domestic income, as a means of reducing imports. In this way, increased unemployment was seen by Keynes as the only mechanism capable of restoring international balance to deficit countries. Of course, the unemployment and fall in income would reduce investment via the accelerator, which, in turn, reduced future productivity, capacity and so on.

Kalecki reached similar conclusions about the importance of domestic full employment policy for the viability of an international system of trade based on multilateralism: ‘multilateralism is certain to realize its advantages only if full employment based on domestic expenditure is maintained in all countries. It is certainly unworkable if employment in major industrial countries is subject to fluctuations’. (Kalecki, 1946 p. 413)

For Kalecki, the key determinant of output was the expenditure decisions of capitalists, in particular their investment decision, which was related to expected profits, which were in turn determined by both current profits and by levels of capacity utilization, both of which were determined by changes in the level of income. Abstracting from government, Kalecki argues that:

In fact, aggregate profits are equal to the capitalist consumption plus investment plus the balance of foreign trade. Profits of a given year were either consumed, invested in the construction of capital equipment and in increase in inventories, or, finally, used for repayment of foreign debts or granting of foreign credits. Kalecki, 1933 p. 164.

Kalecki argues that an increase in an economy’s balance of trade surplus will lead to an equivalent increase in aggregate profits, which will stimulate investment and employment.
However, there is a feedback effect from this subsequent increase in economic activity to an increase in imports, which will reduce the trade surplus.

Kalecki then considers the capital account implications of the trade surplus. An increased surplus in the current account will lead to an equal increase in outflow on the capital account. This outflow may be in the form of debt or equity. In either case, there is no change to the initial increase in domestic investment and economic activity. However, ‘foreign countries’ will become indebted to the capitalists of the surplus country to the extent of the surplus.

Although neither Keynes nor Kalecki analyzed the next round effects, these effects reinforce the initial problem. For the surplus country the foreign exchange surplus increases both domestic profits and the level of economic activity. These will in turn, according to both Kalecki and Keynes, generate increased investment. The increased level of domestic investment will increase both capacity and productivity within the country therefore reinforcing its trade advantage, which will further improve its current account. Thus the initial balance of trade surplus will lead to a virtuous circle of cumulative causation further increasing its advantage over its trading partners. This is reinforced by the implications of the offsetting capital flows. Regardless of whether the capital flows take the form of equity or debt, they have a dual role:

[T]he export surplus enables profits to increase above that level which would be determined by capitalists’ investment and consumption. It is from this point of view that the fight for foreign markets may be viewed. The capitalists of a country which manages to capture foreign markets from other countries are able to increase their profits at the expense of the capitalists of the other countries. …

(Foreign lending by a given country need not be associated with exports of goods from that country. If a country A lends to country B, the latter can spend the proceeds of the loan in country C, which may increase pro tanto its stock of gold and liquid foreign assets. In this case foreign lending by country A will cause an export surplus in country C accompanied by an accumulation of gold or liquid assets in that country. …)
The above shows clearly the significance of ‘external’ markets ... for a capitalist economy. Without such markets profits are conditioned by the ability of capitalists to consume or to undertake investment. It is the export surplus and the budget deficit which enable the capitalist to make profits over and above their own purchase of goods. Kalecki, 1965 p. 51-52
In addition, the capital flow in one direction will, in later periods, lead to income flows, either in the form of dividends and profits, or in the form of interest repayments, in later periods, reinforcing the initial effects of the trade flows.

In the deficit country, on the other hand, the deficit reduces domestic profits, investment and output, unless foreign investment fills the gap. The lower levels of investment further reduce future productivity and capacity and, therefore, the country’s ability to compete on international markets. This problem is reinforced by the movements on the capital account. To pay for the deficit, the country relies on capital inflows. However, today’s solution adds to tomorrow’s problem as those capital flows are subsequently associated with current account outflows in the form of interest or profit payments. Just as with the surplus country, so too with the deficit country a process of cumulative causation is set up, but this time it is encapsulated in a vicious circle of increased indebtedness and reduced competitiveness.

Only to the extent to which the capitalist system lends to the non-capitalist world (or the latter sells its assets) is it possible to place abroad the surplus of goods unsold at home. Only in this way do ‘external markets’ solve the problems of the world capitalist system. Kalecki, 1967 p. 456)

The fundamental problem of the present payment system is that the burden of adjustment lies with the deficit country. Adjustment requires either a devaluation/depreciation of the value of the currency, or tight government policy to reduce income, so as to directly reduce imports. Limits to the efficacy of devaluation/depreciation were noted by both Keynes and Kalecki. Both noted the importance of the static elasticity conditions [the Marshall/Lerner condition], which were unlikely to be met in the case of raw material imports. In addition if successful, a depreciation will invite retaliation. Furthermore, such policies are likely to be resisted due to their inflationary consequences. This leaves policy induced recessions as the main mechanism for adjustment via the

effects on imports. However, this is likely to cause balance of trade problems in other countries. At the same time, the policy will cause a reduction in investment.

Both Kalecki and Keynes argued that if the burden of adjustment was on the surplus country, this would require either an appreciation or an expansion of income, in order to increase imports. In both cases effective demand and profits would be augmented elsewhere. So other countries would also expand\(^2\). This would change the bias of world trade from its current contractionary tendency towards an expansionary one.

In any case it should be noted that it is difficult for a country to run a persistent trade deficit (unless they have net income flows generated through previous trade surpluses). Financing it requires capital inflows, either in the form of equity or debt, which will lead to income outflows in future periods. This will reinforce the current account deficit, requiring further capital inflows and so on, in which case either the country’s foreign debt or foreign owned equity in the country will have to increase. However, both of these depend heavily on the expectations of overseas investors on that country’s future rate of return and exchange rate movements. A permanently increasing ratio between the current account deficit and foreign debt to GDP are unlikely to be sustainable due to the effects on the confidence of foreign lenders and/or investors, so that the capital inflows necessary to finance the current account deficits may not be forthcoming.

All of these problems have been amplified, in recent years, by increased openness resulting from globalization. The more open an economy, the less it is able to protect itself from the ramifications of trade deficits. In addition, international financial markets are more likely to ‘punish’ trade deficit countries via capital flight, or by imposing extremely restrictive conditions on the issue of credit. Each of these will reinforce the contractionary bias of the system.

\(^2\) As noted above, Kalecki believed that this was sufficient to guarantee “its advantages” only if it was coupled with the requirement that all countries maintained full employment.
The neoclassical view of trade imbalances

The main alternative to the view discussed above comes from neoclassical theory according to which trade imbalances are the result of insufficient domestic savings and are not important if other countries are prepared to invest on reasonable terms in countries with a negative trade balance. Given the key position such analysis occupies, both in the economics profession, and in its influence over policy makers, it is important to examine it carefully.

According to this view, investment in a closed economy is limited by the savings decisions of the private sector. In an open economy, this savings bottleneck can be alleviated with the use of investment funds from abroad, either in the form of debt or equity. As a result, high savings levels in one country, far from being the problem envisaged by Keynes and Kalecki, are seen as being advantageous to other countries, which are able to tap into these ‘loanable funds’ in order to finance their own investments3.

There are serious logical and theoretical problems with these arguments. They rest on the loanable funds model, where savings constitutes loanable funds used for investment, and must, therefore, precede that investment. As a result, saving causally determine investment, with the rate of interest equating the two. This idea, of course, is the one which Keynes, in *The General Theory* (and subsequently) attacked. It will be recalled that for Keynes, it is the level of income which equated saving and investment, with the rate of interest being a monetary phenomenon determined by liquidity preference. Subsequently, non-neoclassical economists have identified three serious shortcomings of the loanable funds theory.

First, as changes in the rate of interest will have income and substitution effects with a great probability of them being in opposite directions, it is not possible, *a priori*, to determine the direction or the size of the effect on saving. In other words, it is not possible to describe

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3 The argument been reformulated as the neoclassical ‘twin deficit’ view, and as ‘crowding out’.
theoretically any type of function relating saving to the rate of interest. This is reinforced by empirical evidence, which suggests that there is no significant relation between interest rates and saving, although changes in interest rates may influence the specific assets in which people save (Edey and Britten-Jones (1990) and Honohan (1999) especially p. 98). Rather, saving is mainly determined by the level of income. As a result, because increased investment leads to increased income, this generates the saving necessary to finance it. Any attempt to increase saving will reduce aggregate demand, and reduce income, via the paradox of thrift. According to Chick ‘Until Keynes, investment was assumed to be dependent on saving as the source of finance. Keynes reversed this causal ordering, arguing that investment, financed independently of saving, created additional income adequate eventually to generate an equal volume of investment.’ (Chick, 1987 p. 337).

The second problem with the loanable funds story is the assumption of an interest elastic demand for new capital stock, or the investment function, which was shown to rest on unsound theoretical foundations in the debates known as the capital controversies (Harcourt, 1972 and Samuelson, 1966). These showed that the inverse relation between the rate of interest and the level of investment does not hold up to theoretical scrutiny. In fact, the analysis leads to the rejection of any systematic relationship between the rate of interest and the level of investment.

In any case, even heuristic analysis suggests rejection of a simple systematic relationship between the rate of interest and the level of investment. Investment activity is undertaken when it is profitable to do so. Interest rates enter into the calculation as part of the cost of financing investment. This means that unless there is an expected revenue gain from a new investment project, it does not matter how low interest rates are, investment will not respond. In other words, we would expect investment to be interest inelastic when business does not expect to be able to sell the output of the investment project, that is in a recession. If a company does not expect to generate any increased sales from a new project, then even if the interest rate is zero, it is unlikely to invest
in that project. When the economy picks up, as it moves into boom, sales and expected revenue, the perceived profitability of investment, will improve. Increases in interest rates, under these circumstances, will, by increasing costs, influence profitability and hence are more likely to impact on the level of investment. This suggests that the interest elasticity of investment is a non-symmetric, non-linear function of the level of economic activity. (Stegman, 1994). This story is reinforced by the empirical evidence on the interest elasticity of investment which suggests little if any responsiveness.( See, for example, Milbourne, 1990 pp. 246-8, Eisner, 1991 and Bernstein & Heilbroner, 1991).

Finally, the loanable funds analysis breaks down if there is any financial asset in addition to money, except in the limiting case of an economy in stationary state equilibrium (see Kriesler and Nevile, 2002).

Underlying all these problems with the neoclassical approach is the assumption of full employment of resources in a non-monetary economy. If this is the case then, by definition, investment can only be increased if resources from elsewhere in the economy are freed. Hence the necessity for saving, not as some sort of financial requirement, but to free resources. However, in an economy with unemployed or underemployed resources, there is no necessity for an increase in savings to precede an increase in investment as there are resources not being fully utilized. Even in a world of international capital movements, increases in investment will generate the increased saving necessary to ‘finance’ them. (Dalziel and Harcourt, 1997)

**Monetary Policy in a Global Economy**

Given the contractionary bias imposed by the international monetary system, domestic macroeconomic stabilization policy should play a more prominent role in attempting to achieve full employment and reasonable output growth. However, certainly in the case of monetary policy, and to a more limited extent for fiscal policy, globalization has also eroded their effectiveness, as the next two sections will demonstrate.
It is generally accepted that monetary policy is a blunt and uncertain instrument. (See, for example, Milbourne, 1990) Partly as a result of financial and exchange rate deregulation, the transmission channels have become increasingly unreliable, first in terms of the lag between when the central bank implements changes in interest rates and when these have an impact on the economy, and, secondly, in terms of the size of that impact. Not only is monetary policy associated with ‘long and variable lags’, but there is significant uncertainty as to the size of its impact.

Changes in interest rates will, it is argued, affect the economy through three main channels. The most important, and most direct effect, is through the interest elastic components of aggregate demand. Here certain types of expenditure, particularly private sector investment and consumption, are held to be directly influenced by the rate of interest. As a result, tight monetary policy associated with increases in interest rates immediately lead to reductions in these components of demand. This, via a multiplier process, leads to further reductions in aggregate demand, output and employment, reducing (demand-pull) inflationary pressure. However, the lack of any deterministic relation between interest rates and the main components of domestic private expenditure has been discussed above, and suggests that this channel is of dubious efficacy.

A second channel by which monetary policy may influence the economy is through bank balance sheets. Changes in interest rates will lead to changes in the value of bank’s net assets, which will, in turn, influence their willingness to extend credit. Loose monetary policy, associated with falling interest rates will, ceteris paribus, improve the value of bank assets, and will increase their willingness to extend credit. The reverse is true with tight monetary policy, where the increasing interest rates will be associated with a tightening of credit. Many economists believe that it is through the impact on the availability of credit that the effect of monetary policy is felt on the economy. However, the increased mobility of international capital flows has, to a large extent, undermined the efficacy of this channel. With the increased mobility of international capital, enterprises are no longer limited to domestic markets in their quest for financial resources. Tight
monetary policy may lead to domestic credit rationing, but this is likely to lead to an increase in offshore borrowing, which will, therefore, undo the effect of monetary policy.

The final, less direct transmission mechanism results from the impact of changes in interest rates on the exchange rates. Since mobile international capital is seeking the highest expected return, it will act positively to increases in the interest rate differential between countries. Other things being equal, tight monetary policy, by increasing that differential, will lead to appreciation of the currency. By reducing the domestic price of imports and raising the overseas price of exports, this will reduce both cost and demand inflationary pressures, as well as output and employment.

The indirect impact of interest rates through exchange rates is also not as tight as it is sometimes argued. By influencing the interest rate differential between the home country and the rest of the world, changes in domestic interest rates will influence international capital flows subject to two important provisos. The first condition is that the change in domestic interest rate does change international interest rate relativities, which is not always the case, for example, where the central bank changes interest rates purely as a reaction to changes in international rates. The second is that market expectations, particularly with respect to future exchange rate movements will be of equal importance in influencing such flows.

Although changes in the exchange rate will directly influence domestic inflation rates through their impact on the domestic cost of imported goods and perhaps exports, their impact on output and employment will depend on the price elasticities of exports and imports. In the case of a relatively small open economy, like Australia, which exports mainly raw materials and imports mainly intermediate goods neither exports nor imports are likely to be price elastic, so that the Marshall/Lerner conditions may not be satisfied (see for example, Kriesler and Halevi, 1995) This
means that the main impact of interest rate changes through the exchange rate will be on the price level rather than on output/employment.\(^4\)

However, globalization has eroded the efficacy of even this channel of monetary policy. ‘Enormous movements of speculative capital .. seem to inhibit autonomous monetary policies as governments find it hard to set independent interest rates or control their country’s exchange rate’. (Helleiner, 1999 p. 145)

Even in those countries where monetary policy may have some impact, it is argued that globalization has rendered governments incapable of operating an independent monetary policy. Interest rate is most effective as a macroeconomic policy instrument when it is targeted to the exchange rate. However, interest rate parity theory suggests that countries are unable to have an interest rate significantly different from the ‘world rate’ for any reasonable period of time, and accordingly, cannot target the exchange rate. Although it is well known that empirical evidence does not support uncovered interest rate parity nevertheless, there is strong evidence that increased capital mobility has substantially reduced interest rate differentials, and, therefore, substantially reduced the scope for autonomous monetary policy (See Garrett, 1996 and Lavoie, 2000).

**Fiscal Policy in a Global Economy**

In recent years critics of fiscal policy have stressed the problems that arise when one country tries to ‘go it alone’, which have become more severe with globalization. Arguments in the 1990s against the use of expansionary fiscal policy relied not on analytical economic arguments leading to hypotheses that can be tested by standard methods but on arguments about how businessmen, especially those in financial markets, would react to the use of fiscal policy. The arguments stress the effects of the financial deregulation and globalization. In this context the world-wide integration of financial markets is particularly important. Vast funds cross national boundaries each

\(^4\) It could even have a perverse effect on employment if labour intensive industries are relatively disadvantaged. There
day. Institutions all around the world are linked by computers and professionals can deal as easily in a country on the other side of the world as in their own city. Even from the point of view of fiscal policy, not all the effects of this are bad. Globalization can reduce constraints of government fiscal policy, in the same way in which it can ease the financial constraints on firms, by enabling them to finance expanding expenditure and fiscal deficits by borrowing from international capital markets (Helleiner, 1999 and Garrett, 1996). On the other hand, given that international capital seeks the highest rate of return, the ability of governments to raise certain taxes has been impeded, particularly taxes on capital (Garrett, 1996, p. 88).

The major effect of globalization of financial markets is to give these markets considerable influence on macroeconomic policy. In an influential book, Thomas Friedman (2000)\(^5\) coins the term “golden straitjacket”. He argued (pp.101-111) that to have access to international financial markets a country has to follow a set of rules which make up this straitjacket and if a country breaks these rules it is ‘disciplined’ (his word p. 110) by financial markets either avoiding or withdrawing its money from that country.

The golden straitjacket has in all 16 rules. The three that directly affect fiscal policy are maintaining a low rate of inflation, shrinking the size of the government sector and maintaining as close to a balanced budget as possible. Giving complete priority to price stability over full employment as a goal of macroeconomic policy clearly limits the use of fiscal policy to reduce unemployment.

A rule that requires a continual reduction of the size of the government sector is presumably hyperbole, but a small government sector reduces the size of the effects of automatic stabilisers. Two important influences on the size of those stabilisers are the average rate of taxation and the effect, at the margin, of the changes on the rate of economic growth on the level of transfer

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\(^5\) Page references in this paper are to the 2000 revised edition. The first edition was published in 1999.

\(^\text{is}^5\) Page references in this paper are to the 2000 revised edition. The first edition was published in 1999.
payments. The bigger these the larger the automatic stabilising effects. While the size of these parameters need not depend on the size of the general government sector, they almost always do.

The aim of always achieving a budget balance obviously limits the use of fiscal policy though it does not neuter it altogether. The balanced budget multiplier can still operate and government expenditure can be biased towards labour-intensive areas. Such a bias will both maximise the increase in employment and usually increase the size of the balanced budget multiplier with respect to GDP.

Overall, if all three rules are followed, the use of fiscal policy to stimulate economic activity is severely limited. Therefore, the validity of Friedman’s assertion, that the golden straitjacket must be observed to pacify financial markets, is crucial in evaluating the effects of globalization on fiscal policy.

As Thomas Friedman is a journalist, it is not reasonable to expect him to present detailed research to support his views. What he is doing is reporting what people say about what governs the actions of financial market participants and making the judgement that these reported beliefs are correct. We will look at both these links in the chain of his arguments as they crucially impact on the question of the efficacy of fiscal policy, though it is the second argument that is crucial. Like many other writers in this area, Thomas Friedman tends to support his statements about the actions of financial markets with anecdotes. These certainly show that on occasion financial markets do ‘discipline’ countries in the way Friedman asserts. However, they do not show how systematic this is. Anecdotes in favour of Friedman’s position can be countered with anecdotes against it. Other evidence is needed.

Although there are good reasons why financial markets would be cautious in investing in countries where the rate of inflation is rising, there seems little reason for them to be worried by a stable rate of inflation. High inflation rates may be inherently volatile, but this is not obvious in the case of moderate rates of inflation (say 4 to 10 percent). The Australian experience in the 1980s
was that inflation between 6 and 10.7 per cent, as measured by the implicit gross national expenditure deflator, was no barrier to substantial investment from overseas. Accelerating inflation appears to be the actual concern of financial markets rather than a stable rate of inflation, at least if that rate is moderate.

Given the priority given to price stability, it is not surprising that financial markets spokesmen argue against fiscal deficits. Assuming that deficits do increase economic activity they are likely both to reduce unemployment and increase the current account deficit which puts downward pressure on the exchange rate. Each of these will increase inflationary pressure.

Do financial markets follow rhetoric with action? It is possible to cite individual cases in which financial markets have reacted badly to large or continuous budget deficits and cases where they have not. While the picture is not completely clear cut, the overall picture arising from systematic research is that ‘governments still have policy choices and fiscal policy may be the most important instrument for choice’ (Keohane and Milner, 1996 p.248). This particular quotation draws heavily on a cross-country study by Garrett (1996) which concludes that monetary policy is constrained by increasing capital mobility, but that the evidence that there are important constraints on fiscal policy is weak. Moreover, Moore (1998) has shown that much of the evidence found to support the loss of national autonomy in policy making is based on the experience of members of the European Economic Community who have gone much further along the road of integration of their economies than is generally the case.

A desire in financial markets to reduce the size of the government sector would not be surprising given that financial institutions make large profits by arranging privatisation of government businesses. However, despite Friedman, it is not clear cut that those in the financial sector argue strongly for smaller government. In any case, whatever the rhetoric, financial market institutions are happy to deal with countries, such as Germany, with a moderate government sector,

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6 Net foreign debt was 6 per cent of GDP in 1981 and 36 per cent in 1990.
and even countries such as Norway, with a large government sector. Rodrik (1996) has pointed out that in general those countries that are most open and integrated into the global economy have large government sectors.

Thus, of the three of Thomas Friedman’s rules relating to fiscal policy only one appears to be of important. Financial markets do not appear overly concerned either with the size of government or about the rate of inflation as long as that rate is relatively stable and only moderate in size. There are many reasons, apart from the reaction of financial markets, to avoid a continuously accelerating rate of inflation. The rule that needs serious consideration is the one relating to budget deficits. Even in this case, the rule is not a cast iron one that should never be broken. There should be no ban on deficits in times of recession. However, it would be prudent to avoid continuing large deficits in times of an adequate level of economic activity.

It is note-worthy that there is no mention of the current account deficit in Friedman’s description of the golden straitjacket. In countries like Australia, with a large foreign debt and a current account deficit that is a high proportion of GDP, problems with financial markets could well arise and add to the pressure not to break the golden straitjacket rules on fiscal policy. If the ratio of the foreign debt to GDP continues to rise, sooner or later foreigners will wonder how much longer the country will be able to service the debt and cease lending to it. This will precipitate a massive depreciation of the countries currency on foreign exchange markets and hence a rapid, painful adjustment to its economy. Moreover, the devaluation may be precipitated by currency speculators before it would occur if foreign investors were left to make the judgement themselves. Nevertheless, there is no clear point or range of values beyond which it is dangerous to go. In the 1990s Australia had a series of years in which the current account deficit was between 5 and 6 per cent of GDP without causing any massive devaluation.

There is one final reason not to avoid otherwise desirable policy moves so as not to upset financial markets. Events in the last few years suggest that international financial markets now pay less
attention to economic fundamentals\(^7\), which it could be thought would be influenced by the golden straitjacket. Movements in the exchange rate for the Australian dollar in the year 2000 are a good example. From December 1999 to October 2000 the value of the Australian dollar fell by 20 per cent against the US dollar and 15 percent against the trade weighted index at a time when the ‘economic fundamentals’, that the financial market supposedly give weight to, were sound. The budget was in surplus. Apart from a once-off effect of the introduction of the GST (a value added tax), the rate of inflation was 2 per cent and not expected to rise significantly. Even the current account deficit was relatively low. Over the next 5 months the exchange rate fell by a further 5 percent before returning to the October level and fluctuating about it. The whole episode is a clear example of some temporary shock to the exchange rate causing a reinforcing downward trend which overshot any equilibrium level.

This type of example reduces the value of following any systematic rules to keep the approval of international financial markets. Nevertheless, it would be foolhardy for any government (except that of the United States) to ignore the attitudes of financial markets altogether when framing fiscal policy. The modified rule against large budget deficits in times of adequate economic activity should be observed. This may prevent some otherwise desirable policies, but it will not hinder the use of fiscal policy to move an economy out of recession. The major constraint it implies on the use of fiscal policy would occur when what is conventionally considered a boom is not in fact a sufficiently high level of aggregate demand to reduce unemployment to an acceptable level.

**Conclusion**

Both Keynes and Kalecki argued that in the conditions of the 1930s, the international payments system gave a contractionary bias to the world economy. The increased integration of international capital markets in the last 20 years has greatly increased this and reduced the scope for independent

\(^7\). For a sceptical view of the concept of “economic fundamentals”, per se, see Harvey 2001
macroeconomic policy to reduce unemployment. Increased mobility of financial capital has substantially reduced interest rate differentials and hence the scope for autonomous monetary policy. There is more scope for autonomous fiscal policy, but in this area of policy also governments cannot ignore the reactions of financial markets. However, even for cautious responsible governments, national sovereignty in economic policy making need not be superseded by tailoring policies to please financial markets. Governments must certainly consider the likely effects of their policies on the actions of financial markets, but experience of the last 20 years suggests that this does not take away all freedom of action.

Nevertheless, the current structure of international financial payments creates a contractionary bias because it puts all the weight of adjustment on countries with current account deficits. Globalization has increased the pressure on such countries. Hence when balance of payment problems arise, countries often rely on contractionary macroeconomic policy as a cure. There are extremely important drawbacks to such a strategy. As well as causing increased unemployment, contractionary policy treats the symptoms but makes the underlying cause worse. Any long term solution requires increased exports, and/or a reduced reliance on imports as a result of domestic import substitution. Both of these require investment in the tradeables sectors. The solution for the short term crises in the forms of high interest rates and contractionary policy, does not provide a conducive environment for investment, in fact it positively discourages it. In other words, the more today’s problems are solved by such policies, the less will be investment, and so the less will be domestic capacity. This, in turn will increase reliance on imports and reduce export competitiveness, so making the problem worse in the longer term. Hence it is not surprising that commentators like McCombie and Thirlwall (1994) and Gruen (1997) see external sector factors as the major constraints on domestic economic activity.

Globalization has both increased the contractionary bias in the current structure of international financial payments and reduced the ability of national governments to use monetary and fiscal policy
to insulate their countries from this deflationary bias. A change in the ‘international financial architecture’ is necessary to reduce the risk of world wide increased unemployment.

References


