THE ECONOMIC IMPACT OF DEFICITS

There continues to be much discussion and concern surrounding Jamaica's fiscal situation, particularly as it relates to the persistent deficit and its impact on the national debt. In the last ten years, the debt and deficit have evolved as a pair of twin beasts feeding ravenously on the fiscal resources, to the detriment of critical social services such as health and education which have often been compromised for the sake of debt servicing. There have also been concerns, and rightly so, regarding the impact of the deficit and debt on the growth of the economy. But what really is this impact? How exactly do fiscal deficits affect economic activity and national income? We will briefly explore these questions by looking at the short-term and longer-term implications of deficit spending.

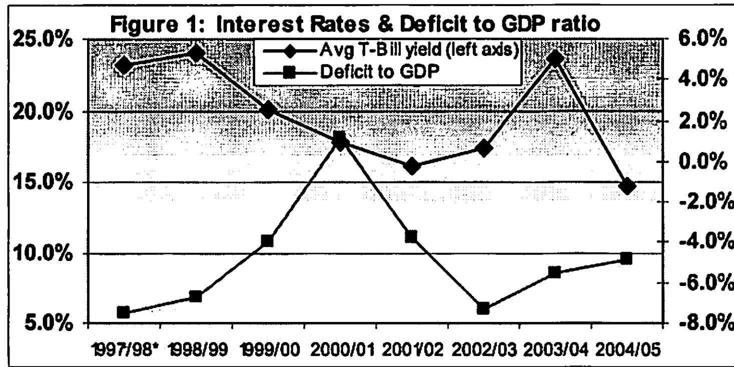
A fiscal deficit is a shortfall between Government's revenues and its expenditures, and this shortfall must be financed by borrowing. There is no single hard-and-fast rule as to how a deficit will affect the economy. This depends on a number of factors, three of which are:

[1] The size of the deficit relative to GDP;
[2] The percentage growth in the debt stock resulting from the deficit, and
[3] The specific areas in which Government carries out its expenditures.

We now examine these factors individually.

[1] <u>Deficit relative to GDP</u>: The deficit figure in and of itself tells us little about its implications for the wider economy. However, by examining this figure as a percentage of GDP, we can look at the deficit in the context of the economic resources that will be needed to ultimately pay for it. Government's expenditures within the economy form part of the nation's GDP, as fiscal spending adds to consumption and ultimately national wealth in nominal terms. Since deficits must be financed by debt, the Government and the nation are borrowing to satisfy today's consumption with an undertaking to repay tomorrow. The deficit-to-GDP ratio therefore represents the burden which will be brought to bear on the economy when the nation is eventually called upon to pay the price for today's additional consumption. Even if the debt is repaid using new debt rather than taxes, this is just a delaying of the inevitable as the shortfall will always represent a charge on the nation's resources.

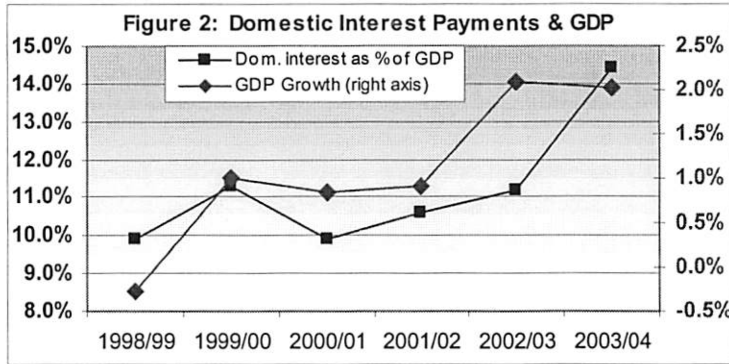
[2] <u>Contribution to the Debt Stock</u>: From point [1] above, we see that the deficit will impact economic activity to the extent that it adds to the country's level of indebtedness. This leads us to the matter of interest rates. The larger a country's debt stock, the greater the perceived risk of default associated with lending to that country and the higher the interest rates that the country will have to pay on its new debt going forward. The capital markets therefore interpret movements in the fiscal performance as changes in the country's future solvency or ability to repay its debts. Figure 1 shows changes in the deficit-to-GDP ratio over the past eight fiscal years as well as movements in interest rates over the same period.



As the figure shows, improvements in the deficit in the first four years of the period were generally mirrored by reductions in interest rates as investor confidence improved. Between 2000/01 and 2002/03, however, the fiscal balance deteriorated from a surplus of 1.2% of GDP to a deficit of -7.3% of GDP, contributing to a reversal of the downward trend in interest rates. Reductions in the deficit-to-GDP ratio in the last two years have encouraged a decline in treasury-bill rates, which fell to an average of 14.68% last fiscal year.

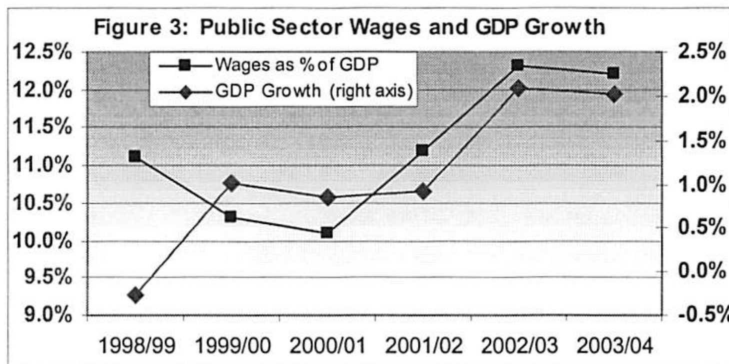
[3] Allocation of Government Expenditures: The third factor determining the economic impact of deficits is the allocation of Government expenditures. Keynesian economic theory argues that government spending can be used to generate growth in an economy; this is because the increased consumption resulting from higher government outlays should have a multiplier effect on national income. While there is no mistaking that increased fiscal spending adds to economic activity, the overall effect on economic growth will depend on the specific areas in which the spending is taking place. For instance, increased expenditure on wages and salaries puts more disposable income in the hands of consumers employed in the public sector, thus boosting aggregate demand and increasing nominal GDP in the short term. However, if this is achieved by running a deficit, this will tend to drive up interest rates and ultimately crowd out business investment, with the result that the productive sectors cannot expand quickly enough to meet the growth in aggregate demand. This in turn could result in inflation, ultimately leading to a slowdown in economic growth in real terms.

In Jamaica's case, public sector wages have contributed significantly to nominal GDP, amounting to some 11.4% of that figure last fiscal year and 12.2% the year before. However, in order to sustain this wage bill as well as the massive cost of debt servicing, the country has incurred a chronic fiscal deficit which has cost us dearly in terms of real economic growth over the medium term. Nevertheless, the short-term effects of increased fiscal spending can be quite pronounced if it facilitates a growth in consumption which is compounded by a multiplier effect in the economy. This is not only true of wages but also domestic interest payments, as these represent a source of disposable income for the holders of government securities. Figure 2 shows domestic interest payments as a percentage of GDP from 1998/99 to 2003/04, as well as GDP growth for the same period.

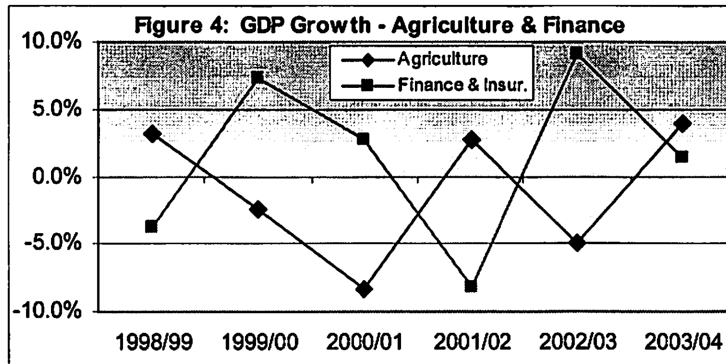


The chart reveals that higher interest-to-GDP ratios were generally associated with higher GDP growth rates over the six-year period. While the data does not conclusively prove the impact of interest income on growth, we can surmise that this income source was one of the contributors to aggregate consumption from year to year.

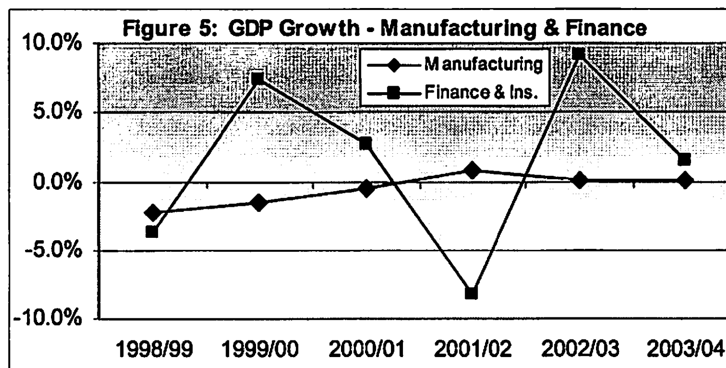
Similarly, increases in wages as a percentage of GDP have generally been accompanied by higher GDP growth, as consumption would have been influenced by increases in total salaries (see Figure 3).



From a production standpoint, deficit spending and the resulting interest rate environment have had mixed effects on the various industries of the economy. While the financial sector has enjoyed some growth as a result of high interest rates in the past, the same interest rate regime has contributed to stagnation in the manufacturing and agriculture sectors. This was the case during the six-year period from 1998/99 to 2003/04, when the treasury-bill rate averaged almost 20%, significantly raising firms' cost of capital in those sectors. Deficits can therefore impact the financial and real sectors in two totally opposite ways, as evidenced by the disparate outturns in agriculture versus finance (see Figure 4).



Similarly, the manufacturing sector experienced minimal growth and in fact posted three consecutive years of decline from 1998/99 to 2000/01 (Figure 5).



Conclusion

From the above, we see that deficit spending can contribute to a rise in nominal GDP in the short term, but a deceleration in real growth in the medium to long term. The stimulus provided by excess Government expenditure often does not translate to an increase in real output as the operation of a deficit tends to drive up interest rates; this prevents the productive sectors from being able to fully respond to the rise in aggregate demand. However, the severity of this 'crowding out' effect will depend on the degree of openness of the economy. In some countries with highly open economies, firms can borrow capital from abroad to finance their investments and so the existence of a fiscal deficit would not seriously impair business growth. In assessing the impact of deficit spending, an important consideration is the amount and quality of capital expenditures that the Government is carrying out. Some infrastructural investments such as roads and bridges can help lay the foundation for future economic growth through greater efficiencies in transport and other areas.

Sources: Ministry of Finance & Planning,
STATIN

Prepared by the PSOJ Research & Financial Services Unit

May 13, 2005