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### Review Of "Public Sector Deficits And Macroeconomic Performance" Edited By W. Easterly, C. A. Rodriguez, K. Schmidt-Hebbel

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Review

Reviewed Work(s): Public Sector Deficits and Macroeconomic Performance. by William Easterly, Carlos Alfredo Rodriguez and Klaus Schmidt-Hebbel

Review by: Stephen A. O'Connell

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war period at the International Economic History Congress at Leuven in the summer of 1990 (*The Role of Banks in the Interwar Economy*. Edited by Harold James, Hakan Lindgren, and Alice Teichova. Cambridge University Press, 1991). This volume, one result of a research program initiated by the European Science Foundation on the economic history of Europe between the two world wars, is a valuable addition to this literature. It is more than a conference volume though there was a conference (in Venice in January 1992) on the way to its completion.

The collection opens with a masterly and thoroughly up-to-date survey of "Banking, Finance and Trade in Europe Between the Wars" by Charles Feinstein, Peter Temin, and Gianni Toniolo (who played a major role in organizing the conference in Cambridge mentioned above and who also contributes the chapter on Italian banking later in this volume); it should immediately find its way on to all reading lists for graduate and undergraduate courses in international economic history. In Part I Charles Feinstein and Katherine Watson also contribute a comprehensive survey of the available data on private international capital flows in the 1920s and 1930s. The other two chapters in Part I, which is intended to set the major themes in a broad international context, not just a European one, are less successful. Joost Jonker and Jan Luiten van Zanden's "Method in the Madness? Banking Crises Between the Wars, an International Comparison" (Ch. 2) is an attempt statistically to distinguish and identify different types of banking crises ("hidden crises," panics, and real banking crises) but the conclusion they draw—that "the banks' behaviour was perfectly rational in the circumstances" of the inflationary 1920s (p. 91)—seems rather obvious and superficial. Barry Eichengreen and Beth Simmon's "International Economics and Domestic Politics: Notes on the 1920s" (Ch. 4) also arrives at unsurprising conclusions, but they admit that

all we have done is to provide [a] suggestion. Much research remains to be done to establish the nature and robustness of the link running from electoral institutions in particular, and political institutions in general, to economic policy decisions and outcomes. (p. 146)

Part II provides comparative analyses of the exchange-rate policies of four pairs of countries: Germany and the U.K. (by Theo Balderston), France and Italy (Jean-Charles Asselain and Alain Plessis), France and Belgium (Isabelle Cassiers), Finland and Sweden (Tarmo Haavisto and Lars Jonung). This is an excellent idea and the papers are interesting and readable. Although they do not add much to our existing knowledge of the formulation and effects of the exchange-rate policies adopted by the major countries, they provide a good introduction to the literature on the international monetary policies of these countries and on the less well known experiences of Finland and Sweden. More informative and innovative are the accounts in Part III of interwar developments in the banking and financial systems of several European countries, including the smaller ones. They draw on a large body of recent research—much of it the authors' own—in many books and journals (and many languages). Where else could one find in a single volume authoritative accounts of banking, currency, and finance in interwar Austria (Fritz Weber), Britain (Forrest Capie), Bulgaria (Ljuben Berov), France (Michel Lescure), Germany (Gerd Hardach), Greece (George Dertilis and Constantine Costis), the Irish Free State (Cormac O'Grada), Italy (Toniolo), Norway (Helge Nordvik), Poland (Zbigniew Landau and Wojciech Morawski), Portugal (Jaime Reis), and Spain (Pablo Martin-Acena)? These will make this volume a lasting work of reference.

SUSAN HOWSON

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## O Economic Development, Technological Change, and Growth

*Public sector deficits and macroeconomic performance*. Edited by WILLIAM EASTERLY, CARLOS ALFREDO RODRIGUEZ, AND KLAUS SCHMIDT-HEBBEL. Oxford and New York: Oxford University Press for the World Bank, 1994. Pp. xiii, 562. \$49.95. ISBN 0-19-520988-5. JEL 95-1257

Persistently high budget deficits are the result of policy failures, not exogenous events, and they are bad for growth. On the way to

these conclusions, this important book clarifies and advances many of the central debates regarding the macroeconomic effects of public sector deficits in developing countries. The result of a major World Bank research project, the book presents detailed case studies of public sector deficits in eight developing countries in the 1970s and 80s (Argentina, Chile, Colombia, Cote d'Ivoire, Ghana, Morocco, Pakistan, and Zimbabwe). An excellent synthesis chapter by Easterly and Schmidt-Hebbel motivates the issues, sets out the empirical methodology, and summarizes the findings. Rodriguez contributes a chapter on the external effects of fiscal policy, and an afterword by Vito Tanzi suggests an agenda for future work. The book will be of substantial use to both policy makers and researchers.

The synthesis chapter is arranged by topic rather than by country. Supplementing the case studies with panel data for a much wider set of developing countries (the data are provided in an appendix), the authors deal in turn with measurement issues, sustainability calculations, and the causes and macroeconomic effects of deficits. The analysis is grounded fully in the public sector's budget constraint and its interaction with the broader macroeconomic accounts, a principle that pervades the book and is one of its major contributions. The synthesis is rich in empirical observations, each linked by the editors to first order policy issues. Thus: cross country correlations between the deficit and any single indicator of macroeconomic imbalance (e.g., inflation) are close to zero; this is evidence that alternative ways of financing a given deficit have different macroeconomic effects. Seigniorage typically provides less revenue than a country's largest single excise tax, and at steeply increasing marginal costs; revenue motivations therefore cannot explain persistent cross-country inflation differentials. Public capital crowds in private capital in some case study countries and crowds it out in others; public capital that produces private goods and services does particularly poorly on this score.

The synthesis provides thorough coverage of the effects of deficits on private saving, the current account, and the real exchange rate.

The causes of deficits, in contrast, receive fairly perfunctory treatment; a mechanical decomposition distinguishes changes due to external shocks from those due to policy influences. While this helps to establish the culpability of policy makers in secular changes in the deficit, more sophisticated (but informal) discussion is left to the case studies and Tanzi's afterword.

Deficits create government liabilities that must be absorbed either by the domestic private sector or by foreign creditors. Much of the book is concerned with the macroeconomic effects of this financing choice. In Chapter 2, Rodriguez develops a useful empirical framework by disaggregating the financial side of the two-sector dependent economy model. In monetarist fashion, portfolio equilibrium determines prices and interest rates in the short run under full employment; dynamic adjustment comes from asset accumulation by the private sector. A number of the case studies implement the specifications developed here, simulating the effects on inflation and interest rates of monetary vs. bond finance or estimating the effects of deficits on the current account and real exchange rate.

The case studies offer details and contrasts that support the synthesis while often going beyond its topical confines. Ghana and Cote d'Ivoire trace out the positive relationship between fiscal adjustment and growth, while affording a dramatic contrast in the relationship between fiscal policy and the exchange rate regime; Chile and Argentina show episodes of high quasi fiscal deficits, while underscoring that their systemic effects depend on the overall fiscal stance. The authors are well-known policy researchers, and the standard of these studies is generally high. All chapters include econometric and simulation work along with extensive descriptive analysis.

Morocco, Pakistan, and to some extent Zimbabwe pose major challenges of interpretation, because in these countries, large and persistent fiscal deficits did not produce macroeconomic instability during the period of analysis. What explains the contrast with Argentina, or with Ghana in the 1970s? Sustainability calculations point to the virtues of rapid growth (five percent in Pakistan; zero in

Ghana), but without resolving the issue. The book has little sympathy (on empirical grounds) for Ricardian equivalence, and aggregate demand effects are best ignored for medium-term analysis. How much can be attributed to different financing choices? The case studies in question suggest a surprising scope for increases in private saving when governments avoid heavy reliance on inflationary finance. The emphasis in these countries was on various direct mechanisms of forced saving, including compulsory absorption of government securities by the non-bank financial sector. The case study authors stress the ultimate limits of noninflationary domestic finance, citing crowding out and unpleasant monetarist arithmetic; but one is tempted to conclude that the limits of inflationary finance, in terms of deteriorating macroeconomic performance, are reached much more rapidly. This issue will certainly receive further scrutiny in the literature, aided by this entire set of case studies.

To conclude, this book demonstrates the benefits for comparative work in macroeconomics of a coherent analytical framework, a clear and limited focus, and a willingness to let the data tell different stories in different contexts. The editors mount a convincing overall argument in favor of stable and low public sector deficits. The book deserves a very wide readership.

STEPHEN A. O'CONNELL

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*Reflections on human development.* By MAHBUB UL HAQ. New York and Oxford: Oxford University Press, 1995. Pp. xix, 252. \$38.00, cloth; \$12.95, paper. ISBN 0-19-510191-X, cloth; 0-19-510193-6, pbk. *JEL 96-0748*

Every teaching economist confronts the problem of justifying the fixation on GNP as a measure of national well being. Students always anticipate the practical problems of valuing "bads" like pollution, crime, suicide, and poverty. They resist theoretical browbeating ("With these household-specific shadow prices, national income is the right measure . . ."). At the end of the day, everyone is happy to move on with the apology that there is no reasonable alternative. Mahbub ul Haq offers a way out of this unsatisfactory di-

lemma. He led a team of economists at the United Nations Development Programme in developing the Human Development Index (HDI). Produced annually since 1990, the HDI aggregates GNP per capita, literacy levels, and life expectancy. The power of the index is not its theoretical rigor, but rather its practicality. It has become a reasonable alternative to GNP in ranking countries according to well being, and is used extensively in classrooms. This book, a collection of short magazine-style essays, presents some of the development and welfare issues suggested by the HDI.

Half of the essays are proposals for a more human oriented and sustainable development. Few will argue with the thrust of these appeals to decency: every child should have the opportunity to drink clean water and attend a primary school to learn to read and write. The specifics, however, are a hodgepodge of ideas (e.g., an Islamic Science Foundation, increased reporting of military transactions), some of which border on the utopian: "What we must insist on today is a compensation package from rich nations for imposing immigration controls . . ." (p. 120); and Chapter 16, a call for an Economic Security Council to match the present U.N. Security Council. The lack of focus is unfortunate. The author has a serious and modest proposal to have donors and developing countries alike target 20 percent of their budgets to human development. This "20:20 vision" should have been the central concept of the book, bolstered by an analysis quantifying the improvements in the HDI, especially in terms of the tradeoff between possibly slower GNP growth and faster progress in literacy and life expectancy. Instead we find it buried in Chapter 15, almost an afterthought.

The core of the book explores three propositions: (1) GNP growth alone will not satisfy the basic needs of the world's poor; (2) implementation of a basic needs agenda is feasible through reallocation of spending; and (3) an unholy alliance of "shock therapists" and Bretton Woods institutions is impeding redistribution and provision of basic needs. Two chapters use the HDI to demonstrate the lack of close correlation (assumed in so many classrooms) between GNP and a country be-