Flash Economics

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Market discipline never works

Market discipline is a situation in which a country's authorities are encouraged to return to a serious, rigorous economic policy (primarily fiscal) due to the deterioration of financial markets (currency depreciation, rising interest rates) that occurs when lax policies are pursued. These lax policies lead to the emergence of both a very large public deficit and a very large external deficit.

But analysis of past historical episodes shows that there is no market discipline. In reality, financial markets do not react to abnormally expansionary fiscal policies or massive external deficits and deteriorate abruptly rather than gradually. There is crisis, not incentive to correct economic policies. This was observed in southern European countries (Greece, Spain, Portugal) before the Euro zone crisis in 2010; it is probably being observed today in the United States and France.

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Definition of market discipline

Let us assume that a country experiences **a sharp increase in its public deficit and a significant deterioration in its trade balance** due to highly expansionary policies (mainly fiscal). If market discipline prevails, this situation will lead to a gradual deterioration **in the bond market** (slow and steady rise in interest rates) **and the foreign exchange market** (currency depreciation). Of course, if the country is part of a monetary union, there can be no currency depreciation, only a rise in interest rates.

This deterioration in the bond and foreign exchange markets, if market discipline prevails, is gradual and **provides an incentive to return to more restrictive policies** and pursue stabilization policies.

But historical precedents show that there is no market discipline

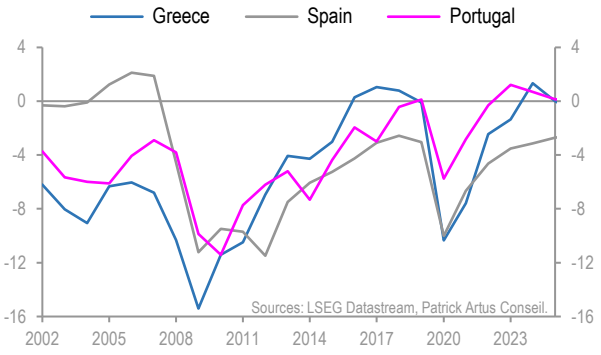
If there is market discipline, and if excessively expansionary policies are pursued that result in a large external deficit and a large public deficit, then we would expect financial markets to gradually deteriorate, giving the country's government time to implement corrective policies and return to a less expansionary economic policy stance (primarily in terms of fiscal policy). **In reality, we are seeing a different trend**: for a long time, financial markets do not react to public deficits and external deficits, then suddenly there is a financial crisis that forces a sudden and abrupt adjustment of economic policies

This dynamic was very visible **in the southern Euro zone countries** (Greece, Spain, Portugal) **during the Euro zone crisis** (2010-2014).

These countries were characterized by:

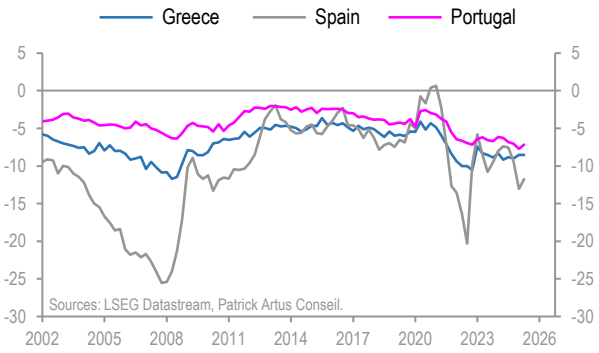
- **A very large public deficit that predated the crisis** (since the early 2000s in Greece and Portugal, since 2008 in Spain), **Chart 1**;

Chart 1
Fiscal surplus or deficit (as % of nominal GDP)



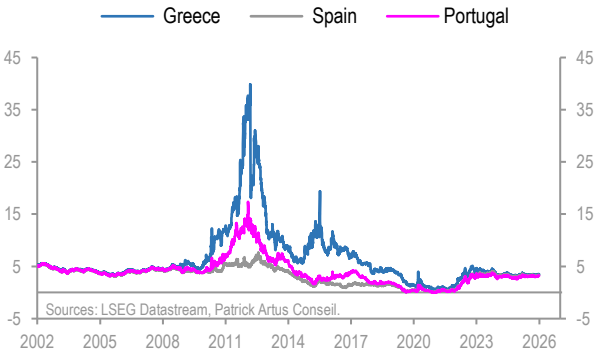
- **An external deficit that also predated the crisis** (since the early 2000s in Greece, Spain, and Portugal), **Chart 2**;

Chart 2
Trade balance in goods (quarterly data, EUR bn)



The budgetary and foreign trade situations therefore deteriorated well before the bond market reacted, with long-term interest rates only rising from 2010 in Greece and from 2011 in Spain and Portugal (**Chart 3**).

Chart 3
Interest rate on 10-year government bonds (as %)



It therefore takes more than two years between the deterioration of the public deficit and the trade balance and the date on which the bond market reacts to these deteriorations.

But when the bond crisis hits, it is brutal and leads to a sharp decline in activity (**Charts 4A/4B**).

Chart 4A
Real GDP (Y/Y as %)

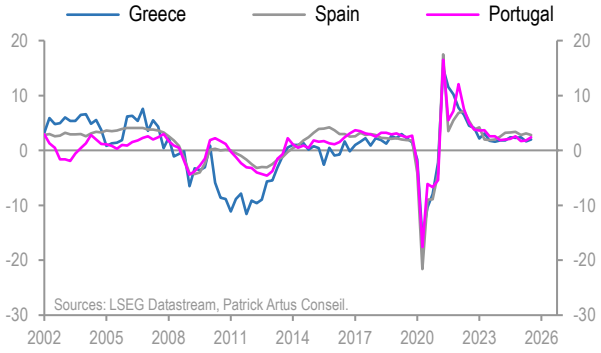
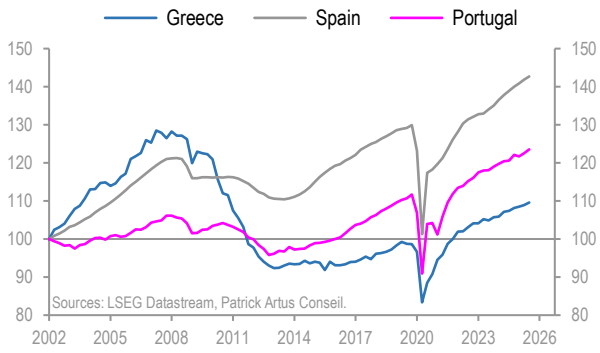


Chart 4B
Real GDP (2002.Q1 = 100)



There was therefore no market discipline that would have given countries time to correct their overly expansionary fiscal policies; instead, there was a sudden crisis, leading to a sharp decline in economic activity.

The same pattern can be observed today in the United States and France

The United States has a very high public deficit and external deficit (**Charts 5A/5B**). If the Trump administration continues to back down on tariffs, and if the household subsidy plan (amounting to $2,000 per American household) is actually implemented, the US public deficit will be close to 9% of GDP for the full year, which will also push up the external deficit.

Chart 5A
United States: Fiscal deficit (as % of nominal GDP)

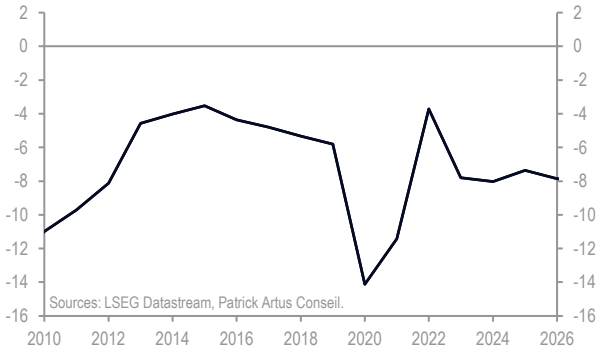
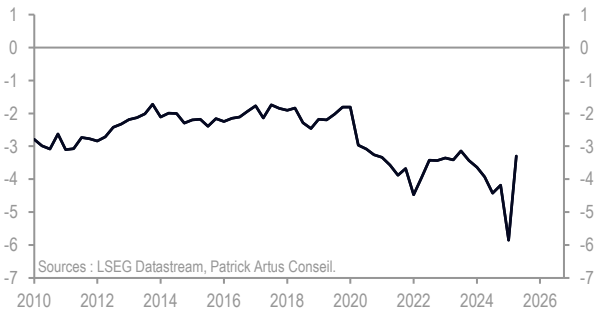


Chart 5B
United States: Current account balance (as % of nominal GDP)



Due to the lack of a majority in Parliament, **France has been unable to reduce its public deficit** (**Chart 6A**). However, its external deficit remains low (**Chart 6B**).

Chart 6A
France: Fiscal deficit (as % of nominal GDP)

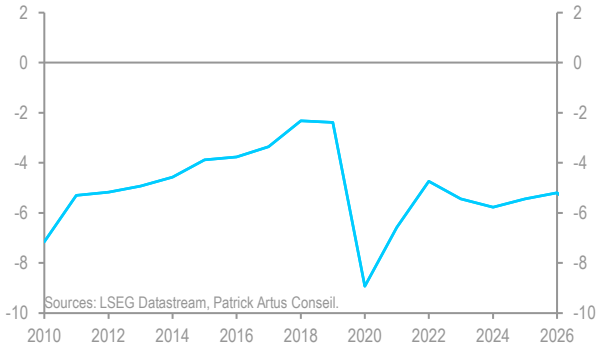
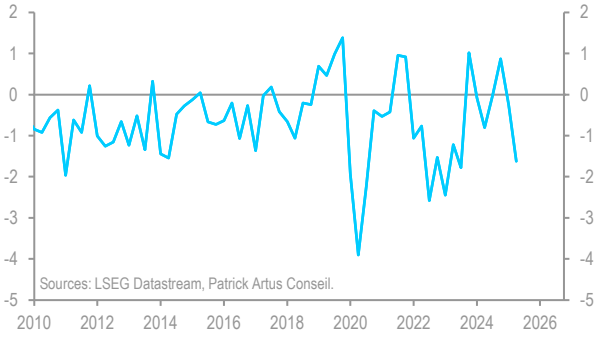


Chart 6B
France: Current account balance (as % of nominal GDP)

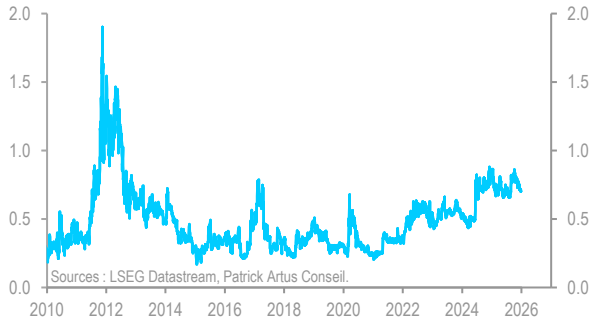


However, the 10-year interest rate in the United States and the 10-year interest rate spread between France and Germany remain fairly low (**Charts 7A/7B**).

Chart 7A
United States: Interest rate on 10-year government bonds (as %)



Chart 7B
France: Yield spread on country's 10-year government bonds against Germany (as % point)

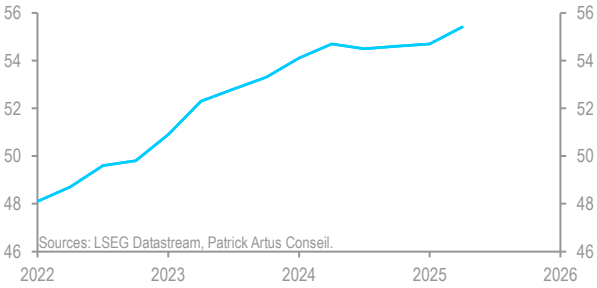


Foreign investors continue to buy government debt from the United States (Chart 8A) and France (Chart 8B), despite the deterioration in public finances.

Chart 8A
United States: Foreign holdings of Treasury securities (USD bn)



Chart 8B
France : Percentage of negotiable debt issued by the state and held by non-residents



Summary: What are the prospects in the United States and France?

We have seen, in the case of the southern Euro zone countries, that market discipline does not work. Instead of an early and gradual deterioration of financial markets in response to economic policies that lead to significant public and external deficits, there has been a sudden and delayed deterioration of markets (bond and foreign exchange), which has prevented the gradual correction of overly expansionary economic policies

In the United States and France, there is also excessive public deficit and, in the United States, excessive external deficit. We must therefore consider the possibility of a delayed public debt crisis in these countries and, in the United States, a sharp depreciation of the exchange rate.

Of course, these two countries enjoy protection against crises:

- In the **United States**, through the international role of the dollar, which attracts capital to the United States;
- In **France**, through investors' conviction that a default on public debt is impossible because it would be unacceptable to the ECB and would lead to mistrust of all financial assets denominated in euros.

Conversely, however, it is hard to believe that investors will remain unresponsive to the certain rise in public debt ratios (Chart 9A) and, in the United States, in net external debt ratios (Chart 9B).

Chart 9A
Public debt (as % of nominal GDP)

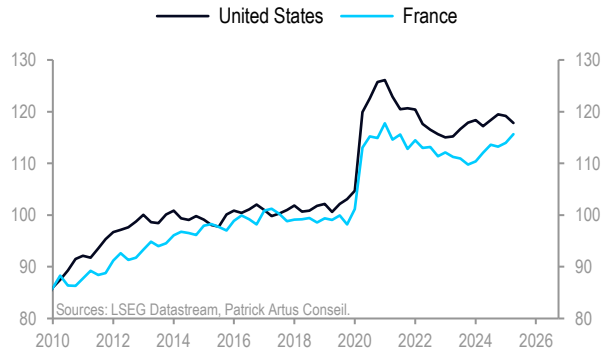
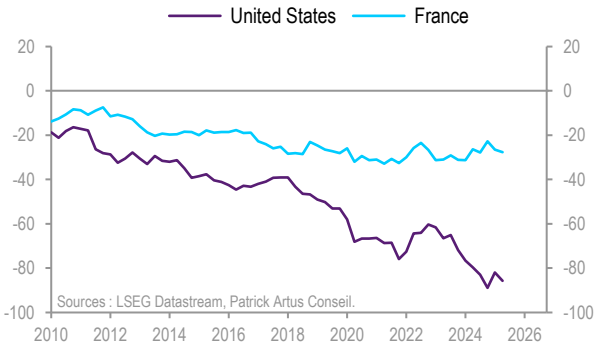


Chart 9B
Net foreign assets or liabilities (as % of nominal GDP)



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