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U.S. Fiscal Policy: Confronting the Lessons of Europe and the Impossibility Theorem

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Sketch of Today's Talk

- The U.S. has run $1 trillion federal budget deficits for four consecutive fiscal years. Is this sustainable?

- Developments in Europe are causing some economists to worry about the sustainability of U.S fiscal policy.

- One complication: Monetary policy is super-easy.

- What can Europe's problems and bit of economics teach us about unsustainable fiscal policy?

Disclaimer

The views I will express are my own and do not necessarily reflect the positions of the Federal Reserve Bank of St. Louis or the Federal Reserve System.

Thinking Long-Term

- Many economists and forecasters argue that an unsuccessful resolution of the outstanding fiscal uncertainties—higher tax rates, sequestration, etc.—will plunge the economy over the "fiscal cliff."
- Over the longer run, though, fiscal policy can have significant consequences for the economy and for monetary policymakers.
- When viewed through this prism, what matters more is the fiscal abyss.

Lessons from Reinhart-Rogoff

- Lesson #1: Sovereign debt crises often follow financial and banking crises.

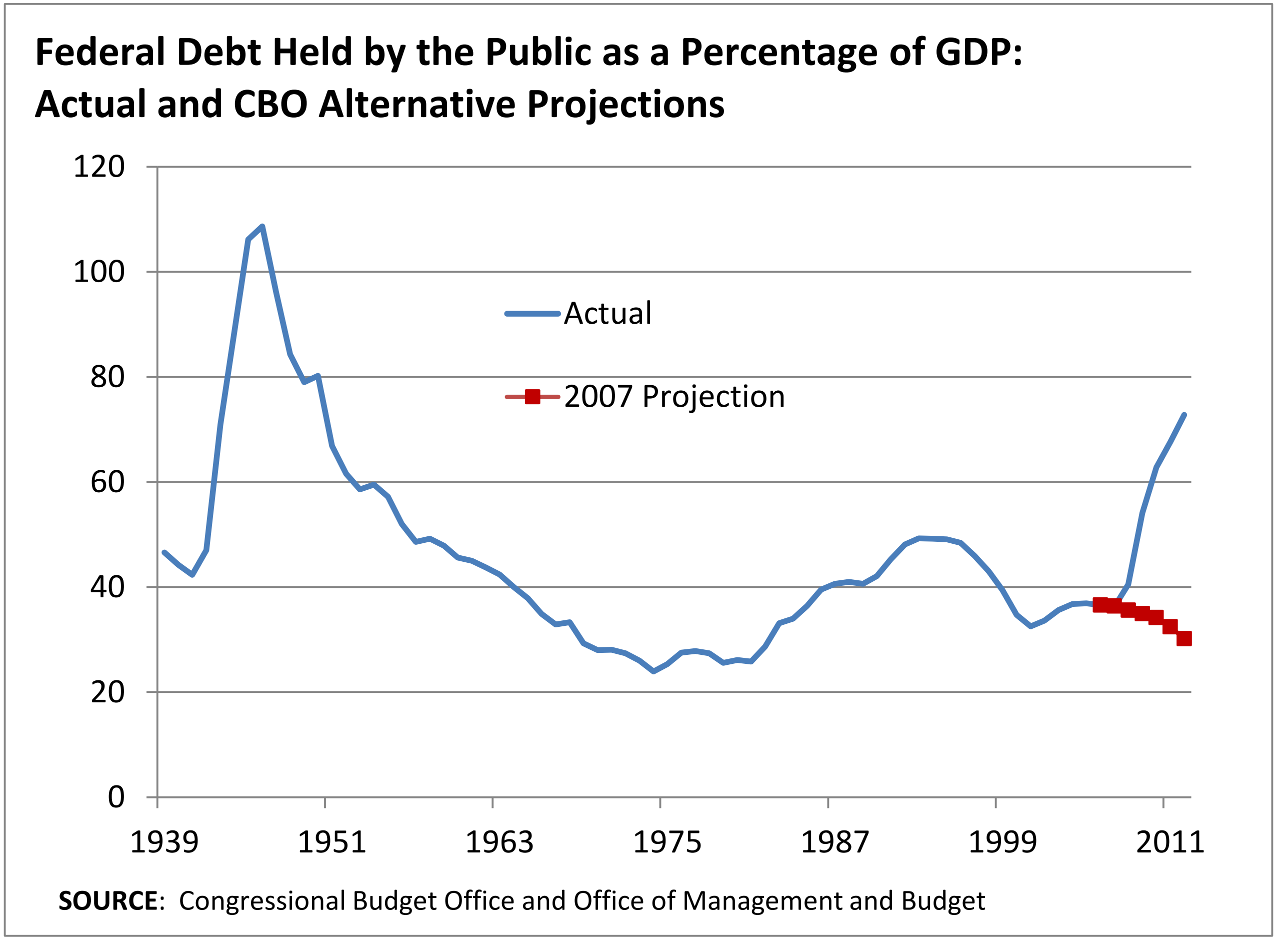
- Lesson #2: Persistently high levels of debt relative to the size of the economy reduces economic growth (living standards).

- Lesson #3: A significant amount of domestic debt has often been a key reason why many governments have chosen to allow high rates of inflation (vs. default)

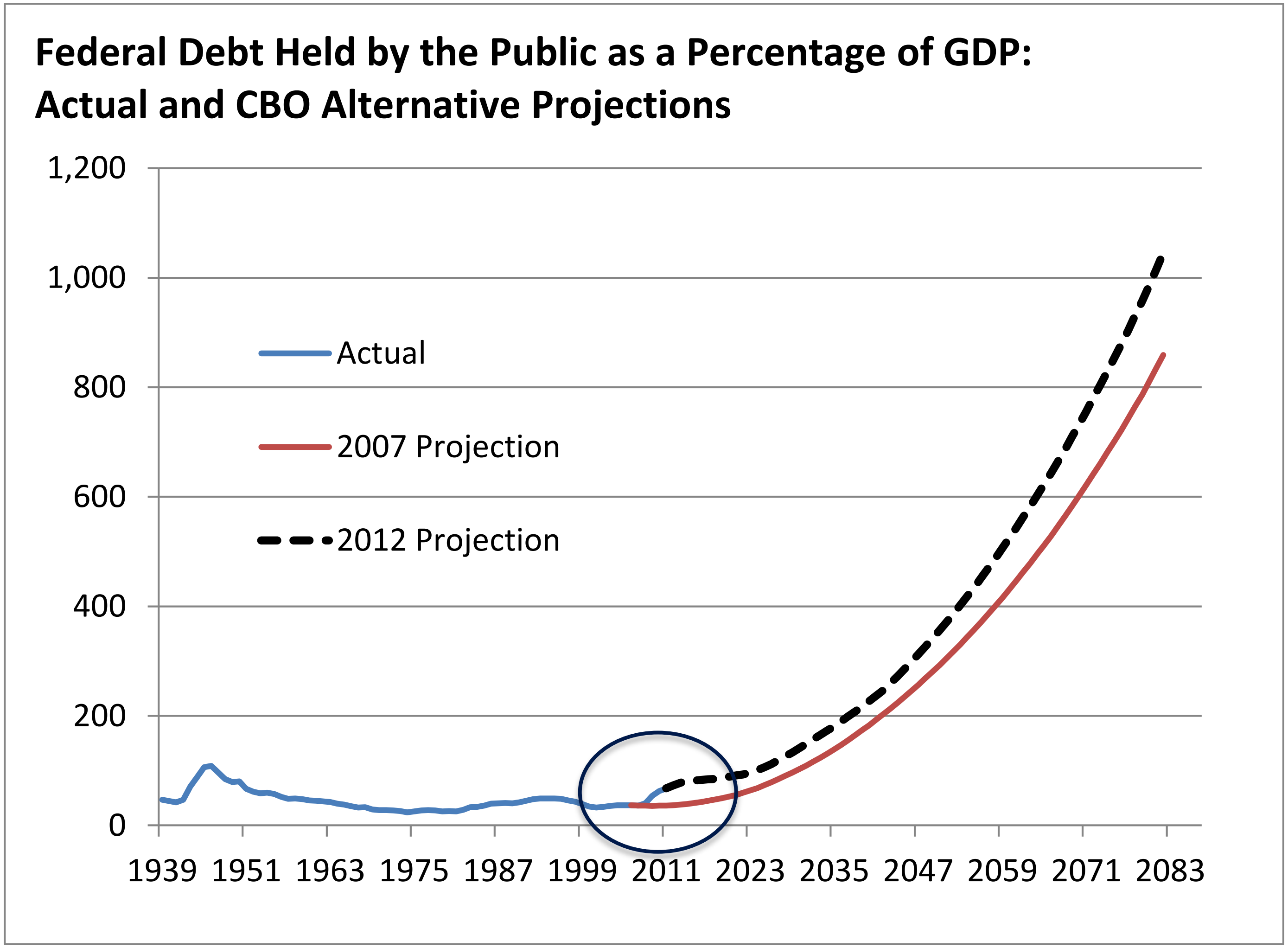
Debt and Inflation

- Some economists believe that a "run from the dollar" scenario could lead to much higher rates of inflation.
- The Fed has adopted an inflation target and the lessons of the 1970s are not too distant a memory—are they?
- Low nominal interest rates and stable long-term inflation expectations suggest markets place a very low probability on higher inflation anytime soon.

- Financial crises and deep recessions tend to have sizable adverse effects on government finances.



- The real problem: On the road to Perdition.



Lessons from History

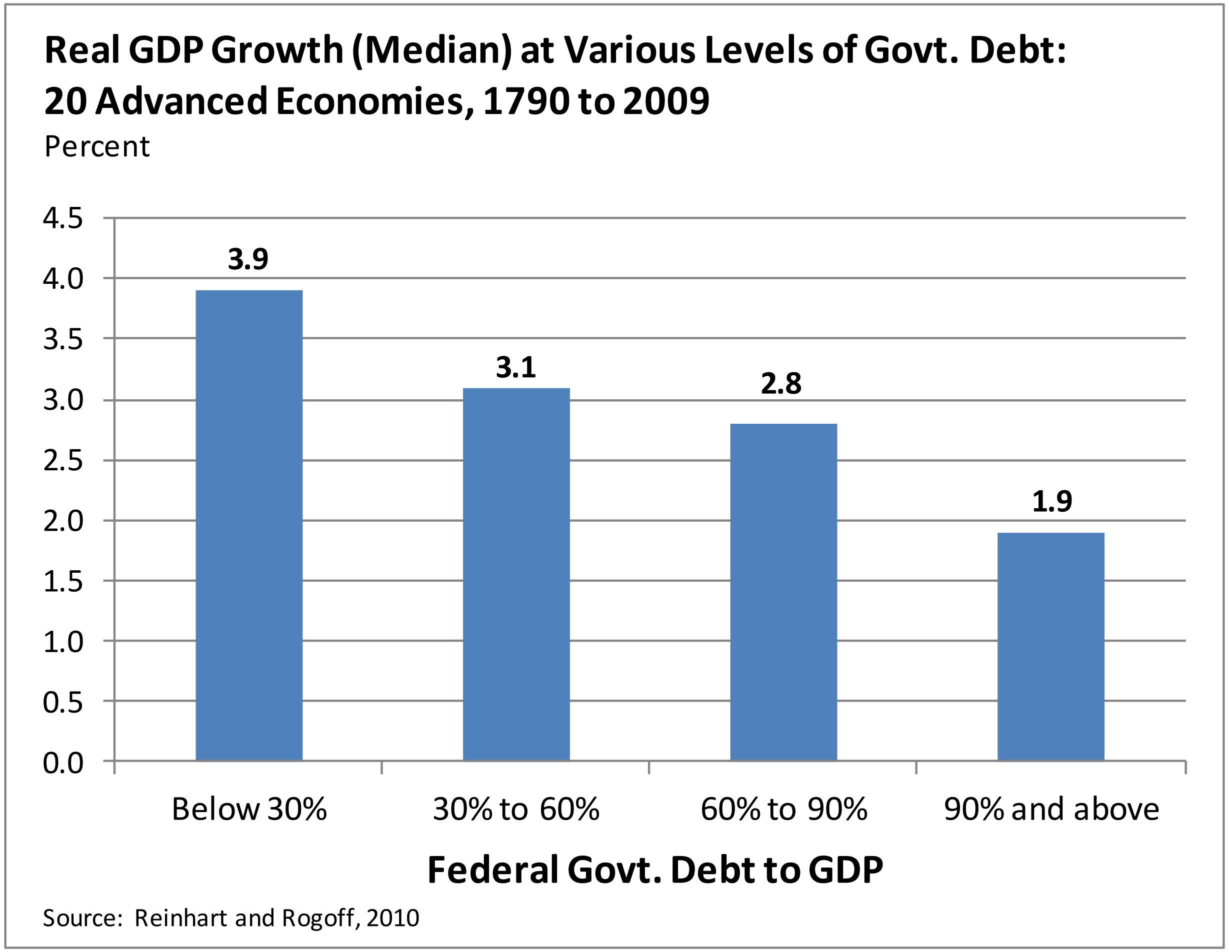
“The progress of the enormous debts which at present oppress, and will in the long-run probably ruin, all the great nations of Europe has been pretty uniform." (Adam Smith, 1776)

The rich rules over the poor, and the borrower is the slave of the lender. (Proverbs 22:7)

Consequences of Fiscal Laxity

- High and rising debt-to-GDP levels imply a larger share of resources flowing to the public sector.
- This means less saving and tangible capital investment and thus smaller gains in living standards.
- Less capital investment and higher future taxes to finance the increased debt will also tend to retard the development and dissemination of new technology.

- Countries with large debt-to-GDP ratios have historically experienced weak growth.



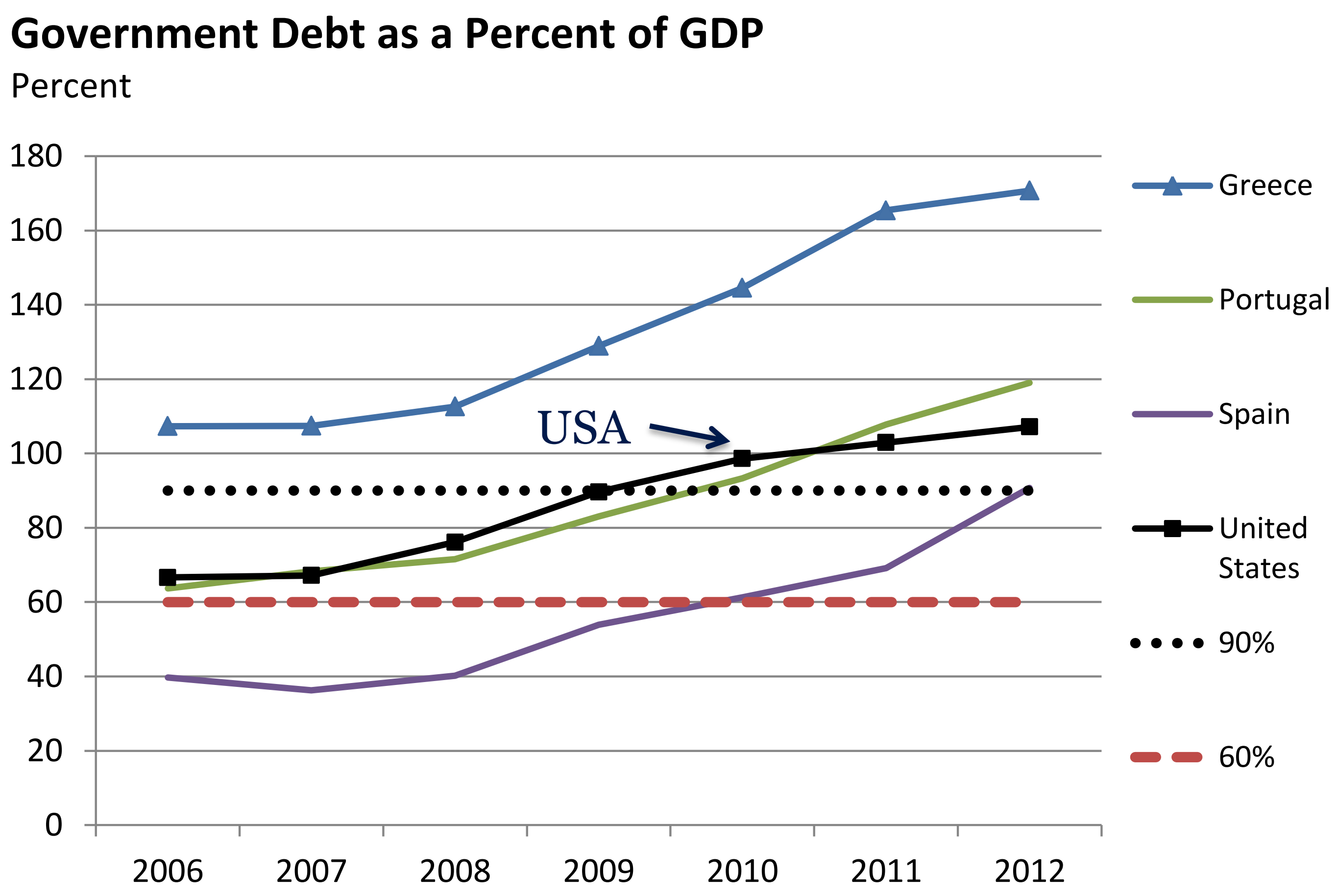
Key Questions

- How sustainable is U.S. fiscal policy? Is there a tipping point for the debt-to-GDP ratio?
- Can we learn something from the recent European sovereign debt crisis?
- What can the economics of public choice teach us?

Debt Sustainability

- The economics of debt sustainability hinge on a few key factors, such as the economy's expected rate of growth relative to the interest rate paid on its debt.
- Reinhart and Rogoff have noted that, historically, many countries have defaulted on their debt when debt/GDP reaches 60%.
- European policymakers enshrined this percentage in their Growth and Stability Pact when designing the euro.

• The United States: Living in a Bad Neighborhood!

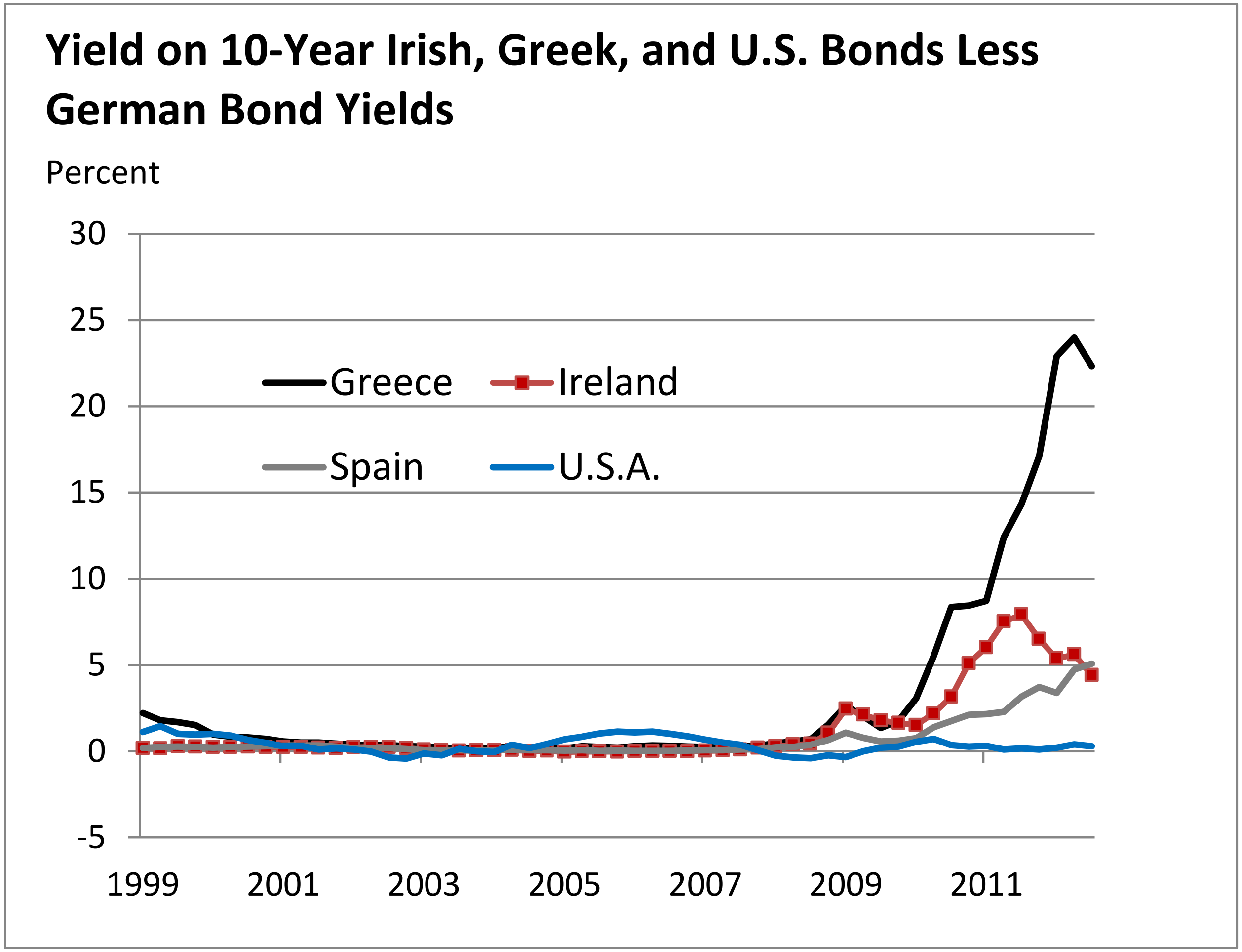


SOURCE: International Monetary Fund.

Lessons from Europe

- Prior to the sovereign debt crisis, most of the countries in trouble now were above the 60% threshold.
- Indeed, before the crisis, Greece was well above 100%—and had no trouble rolling over its debt.
- Sudden stops: A large shock can change market expectations in a hurry. Contagion risks spread rapidly.
- Markets are quicker than politicians in determining the point when a country has too much debt.

- The United States: Reaping the benefits of the world's reserve currency!



Other Lessons

The key issue from the perspective of macroeconomic models is that the debt increases in the United States since 2008 were undertaken without any political consensus concerning the future tax or spending regime. Without a clear statement about future tax and spending regimes, it is difficult to evaluate the situation."

(St. Louis Fed President Jim Bullard, 2012)

Economics of Public Choice

- Can a democracy design a system that stabilizes its debt-to-GDP ratio before a full-blown crisis occurs?
- Yes, but Europe's recent experience suggests it is very difficult.
- One branch of economics claims that majority-rule voting systems have a built-in bias towards an expanded role of government.

Economics of Public Choice

- Self-interested voters vote their pocketbooks, and their representatives have strong incentives to provide benefits for their constituents.

- Arrow's theorem: When voters have different goals, it is impossible to design a system (e.g., tax and spending policy) that pleases everyone.

- The median voter becomes important: policy choices become centrist. Radical proposals are defeated.

Economics of Public Choice

- But the outcome of this dynamic is a policy environment of low tax rates and large government benefits.
- A key lesson of Public Choice theory: Incentives matter.
- Changing political leaders will not change outcomes.
- What is needed, these proponents argue, are rules that limit the growth of spending or tax triggers.

Key Summary Points

- High levels of debt eventually lead to bad outcomes—choices must be made.
- The U.S. benefits from having the world's reserve currency. Reserve currency status does not last forever.
- A key lesson from the European sovereign debt crisis is that markets move faster than political systems.

Questions?