UNIVERSITY OF MISSOURI-KANSAS CITY

Fiscal Space and Financial Stability: A Differential Analysis

The U.S. versus the Eurozone

Stephanie Kelton

FIELDS-INET

October 31, 2013

The Orthodox Perspective: A One-Size Fits All Approach

Government Budget Constraint

$$G + iB = T + \Delta B + \Delta M$$

Assumptions:

Gov't spending is "financed" by $T + \Delta B$

"Financing" gov't spending via ΔM is inflationary

"Constraint" is thus to select G such that $\Delta M = 0$

Intertemporal Budget Constraint

Blanchard et al. 1990

$$\Delta B = G - T + iB$$ (note no ΔM)

Rewriting in real terms and as % of real GDP:

$$\Delta b = g - t + (r - \Theta)b$$

For any time, n, in the future . . .

$$b_N = b_0(1+r-\Theta)^N + \Sigma(g-t)(1+r-\Theta)^{N-k}$$

Taking present value . . .

$$PV\ b_N = b_0 + PV\ \text{projected}\ \Sigma(g-t)$$

$$PV\ b_N = b_0 + PV \text{ projected } \Sigma(g-t)$$

Also, since $PV\ b_N = b_N / (1+r-\Theta)^N$,

then Limit $PV\ b_N$ as $N \rightarrow \infty = 0$

Thus, for fiscal sustainability,

$$0 = b_0 + PV \text{ projected } \Sigma(g-t)$$

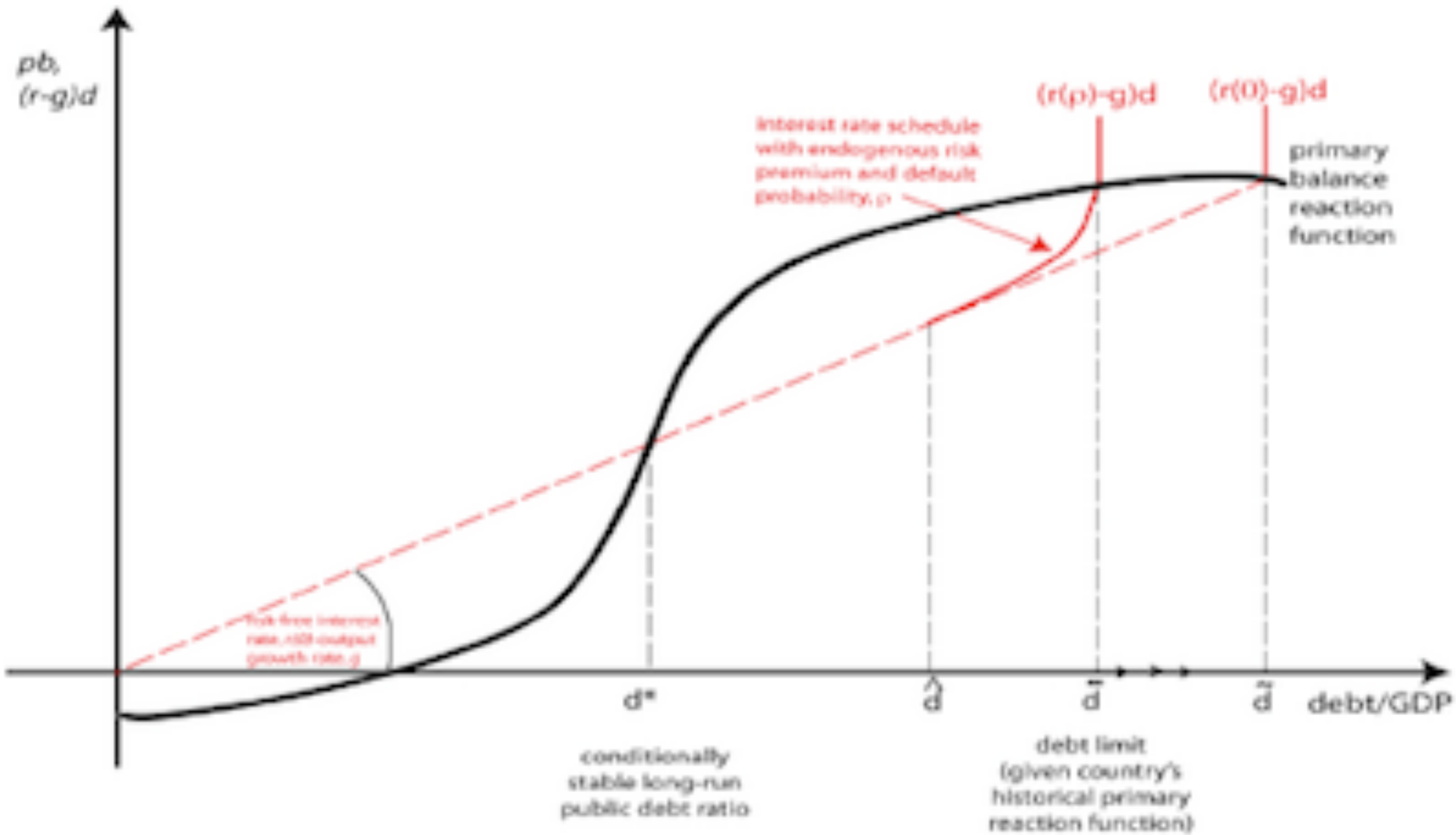
$$-b_0 = PV \text{ projected } \Sigma(g-t)$$

In (Other) Words

- The cumulative discounted present value of the expected future **surpluses** must be equal to the current national debt outstanding

- If that condition is not satisfied, then the government would have to eventually repudiate its debt, either by an outright default or through the use of inflation

Resulting in Something Like This



Bad Assumptions Are Driving the Model

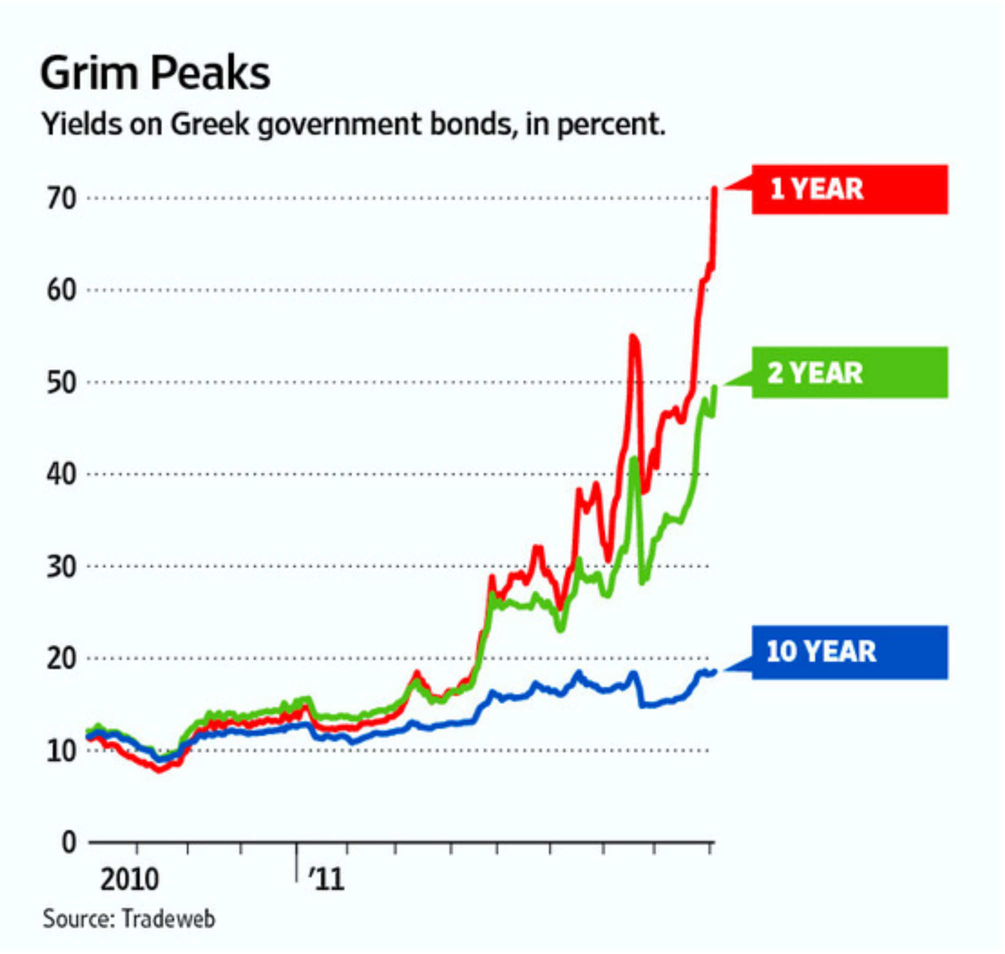
"California's bond rating has sunk to a level just above junk status . . . . California is teaching the U.S. a valuable lesson about the connection between fiscal policy and financial markets."

"Unless action is taken very soon to reform the main U.S. benefit programmes, Washington may have to grapple with the same crisis currently preoccupying Sacramento."

"Unresolved, the situation could cause U.S. Treasury yields to rise sharply, wreaking havoc on the national economy."

Gokhale and Smetters, *Financial Times* (9/7/03)

Isn't that What Happened in Greece?



What's Different About the US?

- In a modern (or sovereign money) system operating **with flexible exchange rates**, interest rates on the national debt are a matter of political economy

- "This has significant implications for the appropriate "mix" of monetary and fiscal policies, particularly if full employment and financial stability are considered fundamental goals of macroeconomic policy."

  ~ Scott Fullwiler, 2006

Fullwiler on "Fiscal Sustainability"

- "In short, the orthodox concept of fiscal sustainability is flawed due to its assumption that a key variable – the interest rate paid on the national debt – is set in private financial markets as in the orthodox loanable funds framework"

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Interest Rates and Fiscal Sustainability

Scott T. Fullwiler
Wartburg College; Bard College - The Levy Economics Institute

July 1, 2006

ver the future path of federal spending on entitlement programs grov
Kotlikoff 1992) have been particularly prominent here. These econor
magnitude of an existing unsustainable fiscal path. They argue that
etters 2003a). Others within the circle have noted the $44 trillion "fis
2003) and in other publications (e.g., Ferguson and Kotlikoff 2003; K
future GDP shows it to be about 7 percent (e.g., Auerbach et al. 200

The MMT Perspective

The Financial Balance Approach to Macro Stability

- Understood by J.M. Keynes and early Keynesians like Nicholas Kaldor, Abba Lerner, and Joan Robinson

- "Lost in the headlong rush over the past three decades of mainstream macroeconomics to become a special branch of microeconomics, which itself appears to have become a special branch of applied calculus in some sort of rather twisted physics envy." (Parenteau, 2009)

“Without an expansionary fiscal policy, real output cannot grow for long.”

~ Wynne Godley, 2000

Why?

- Because the US runs persistent current account deficits

- This has important implications for financial stability

- Godley relied on the sector balance framework to undertake his analyses

- Showed that countries with current account deficits would **need to run budget deficits most of the time**

Why Does it Have to be *Government*?

- The US **household sector cannot net save** in nominal terms (spend less money than it earns) unless some other sector (or combination of sectors) is willing and able to spend more money than it earns.
- It can be the government, the business, or the foreign sector or some mix of the three
- But keep in mind, of the three, a **government** with a sovereign currency (not convertible into fixed quantities of a commodity or another currency on demand) and no debt denominated in foreign currencies is **the only one** of those three **that cannot go bankrupt** and cannot default on its debt while continuously deficit spending – unless it chooses to default for some odd political reason

Is that Responsible?

The Hawks Don't Think So

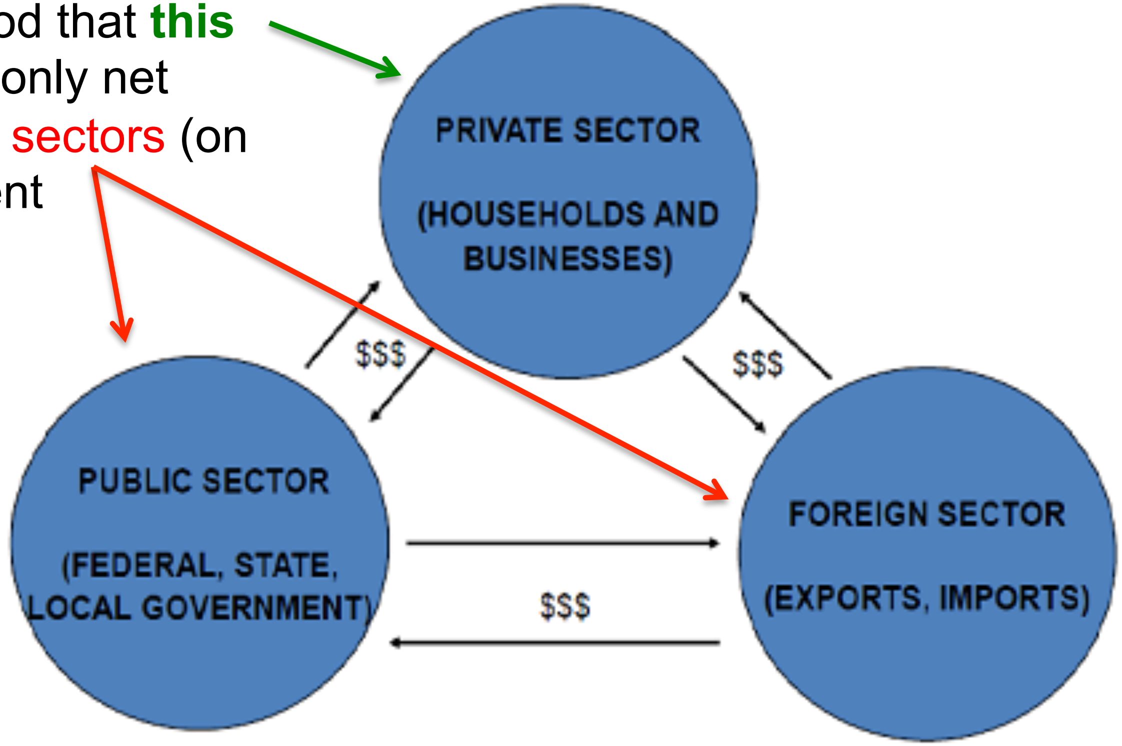
- A deficit hawk opposes deficit spending on principle
- Want immediate cuts and austerity to reduce deficits
- Often favor gold standard or 100% reserve backing
- Would legislate rules to mandate balanced budgets

The Doves Don't Think So

- A deficit dove supports limited deficit spending in tough economic times
- Want the budget balanced over the business cycle
- Support rules to limit the size of the deficit
- Prefer to wait until after the economy begins to recover before imposing austerity

Godley Was a Deficit Owl

He understood that **this** sector could only net save if these sectors (on balance) spent more than their income



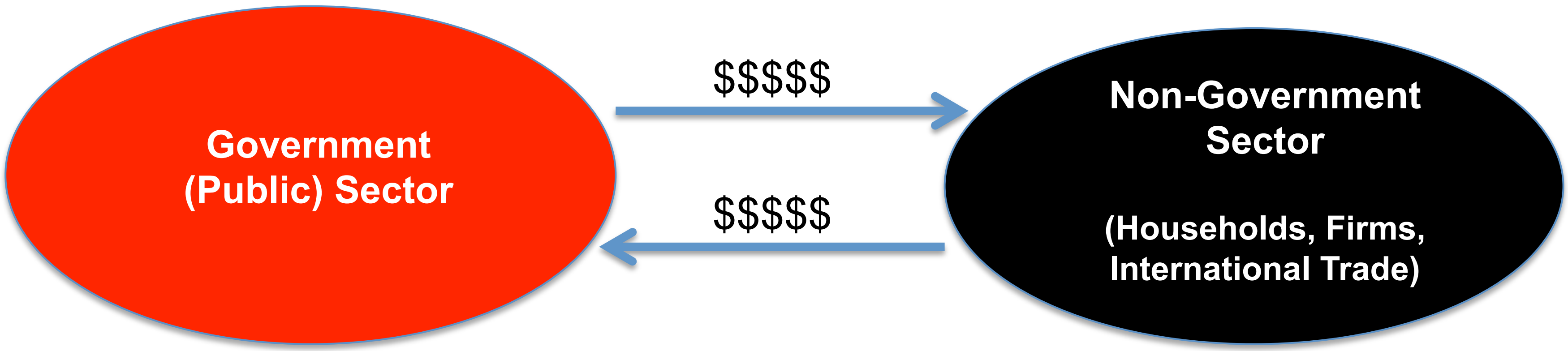
In Any Given Period

- The sector balances show whether a particular part of the economy is:
  - **Spending more** than its **income**
    - Running a Deficit
  - **Spending less** than its **income**
    - Running a Surplus
  - **Spending** just **equal** to its **income**
    - Balancing its Budget

Rules of the Game

- **Three Sectors**
  - – Domestic Private
  - – Domestic Public
  - – Foreign (Rest of the World)
- **Two Rules**
  - – They can't all be in surplus
  - – They can't all be in deficit

Accounting Fact



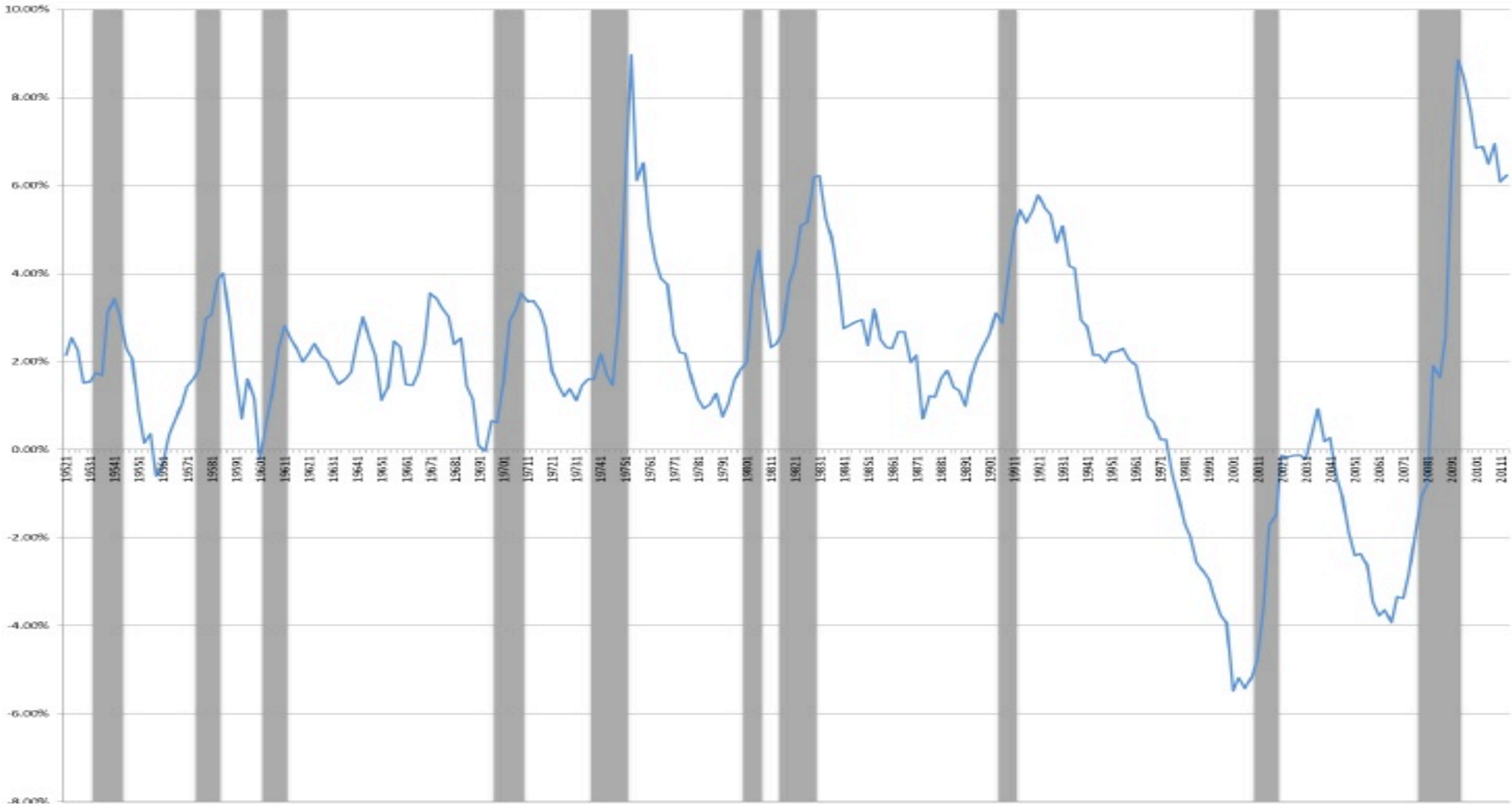
Government Surplus = Non-government Deficit

Government Deficit = Non-government Surplus

In Any Nation

- At least one sector will be in deficit
- Who should it be?
- Godley understood that the **private sector** achieved a "habitual state of surplus" <u>for a reason</u>
- Expansions driven by a *decline* in private net saving were inevitably "followed by a severe recession"

Beware Swings in Private Net Saving



The Private Sector Belongs in Surplus

- "An increase in private debt relative to income can go on for a long time, but it cannot go on forever." (Godley, 2000)

- At some point lenders will run out of creditworthy borrowers who are willing to spend

- "When that happens asset prices go sideways, sales soften, jobless claims trend higher, and economic activity falters" (Wray, 2012)

The Private Sector Cannot Create Its Own *Net* Financial Assets

- Assets and liabilities cancel each other out
  - Loans create deposits
- Net financial assets must come from *outside* the domestic private sector

- Private Sector = Public Sector + Current Account

Private Sector	=	Public Sector	+	Current Account
Surplus		**Deficit**		**Surplus**
(S – I)		(G – T)		(X – M)

- If the Public Sector is running a deficit *and* the current account is in surplus, the private sector will <u>necessarily</u> be in surplus

What if the CA is *Not* in Surplus?

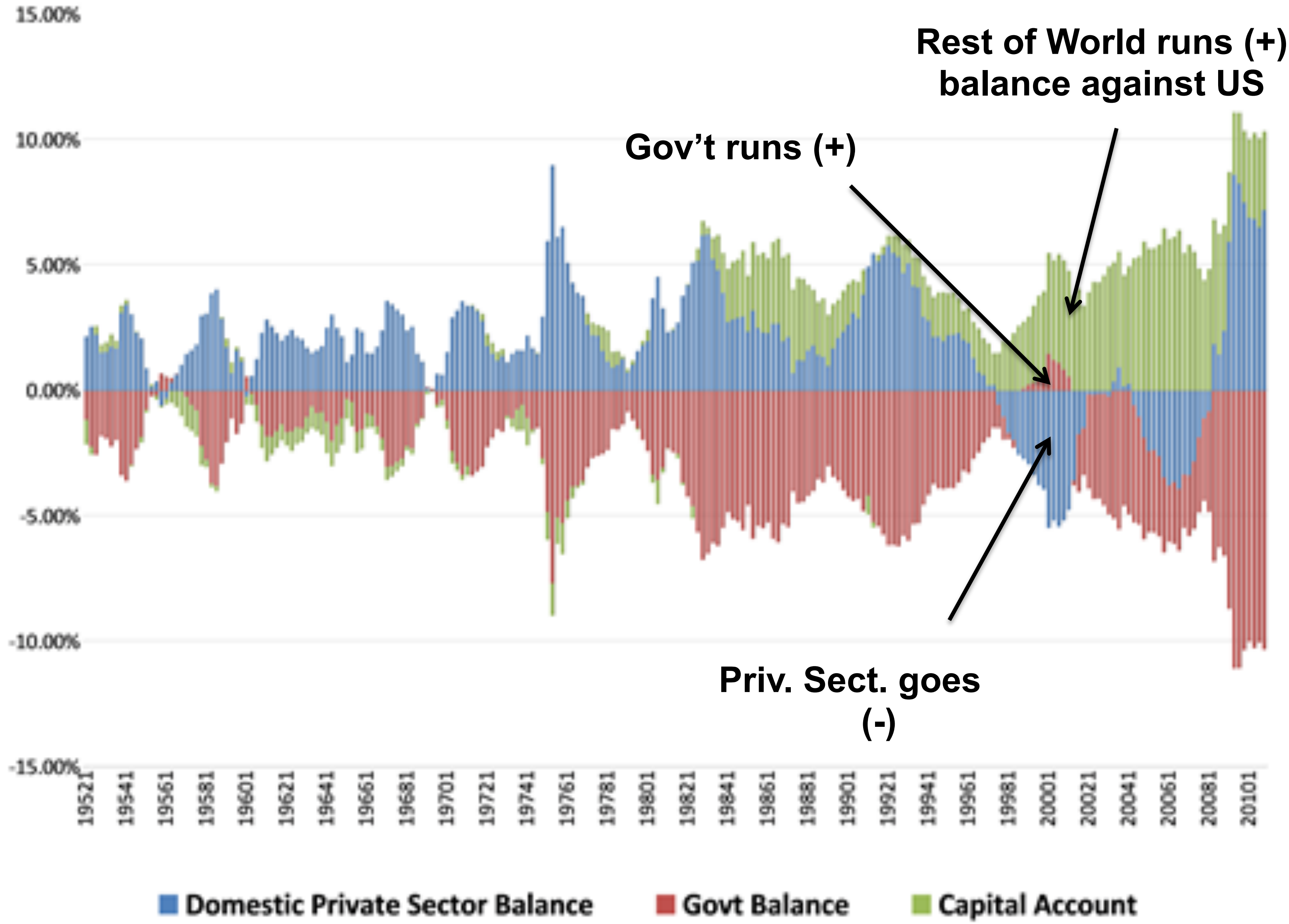
- Can the private sector still achieve a surplus?

- Yes, but only if the government deficit is **bigger** than the current account deficit

EX: 1% = 4% - 3%

- This means that countries with current account deficits <u>must</u> run even bigger budget deficits (as % of GDP) in order to keep the private sector in surplus

Sector Financial Balances as a % of GDP, 1952q1 to 2010q4



What Does this Mean for the EZ?

CA Deficit (2012Q1, Millions of €)

Belgium	-1,422
Estonia	-86
Ireland	-1,045
Greece	-4,721
Spain	-14,444
France	-9,626
Italy	-13,067
Cyprus	-718
Malta	-54
Portugal	-1,264
Slovenia	-77
Finland	-1,191
AVERAGE	**-3,976**

CA Surplus (2012Q1, Millions of €)

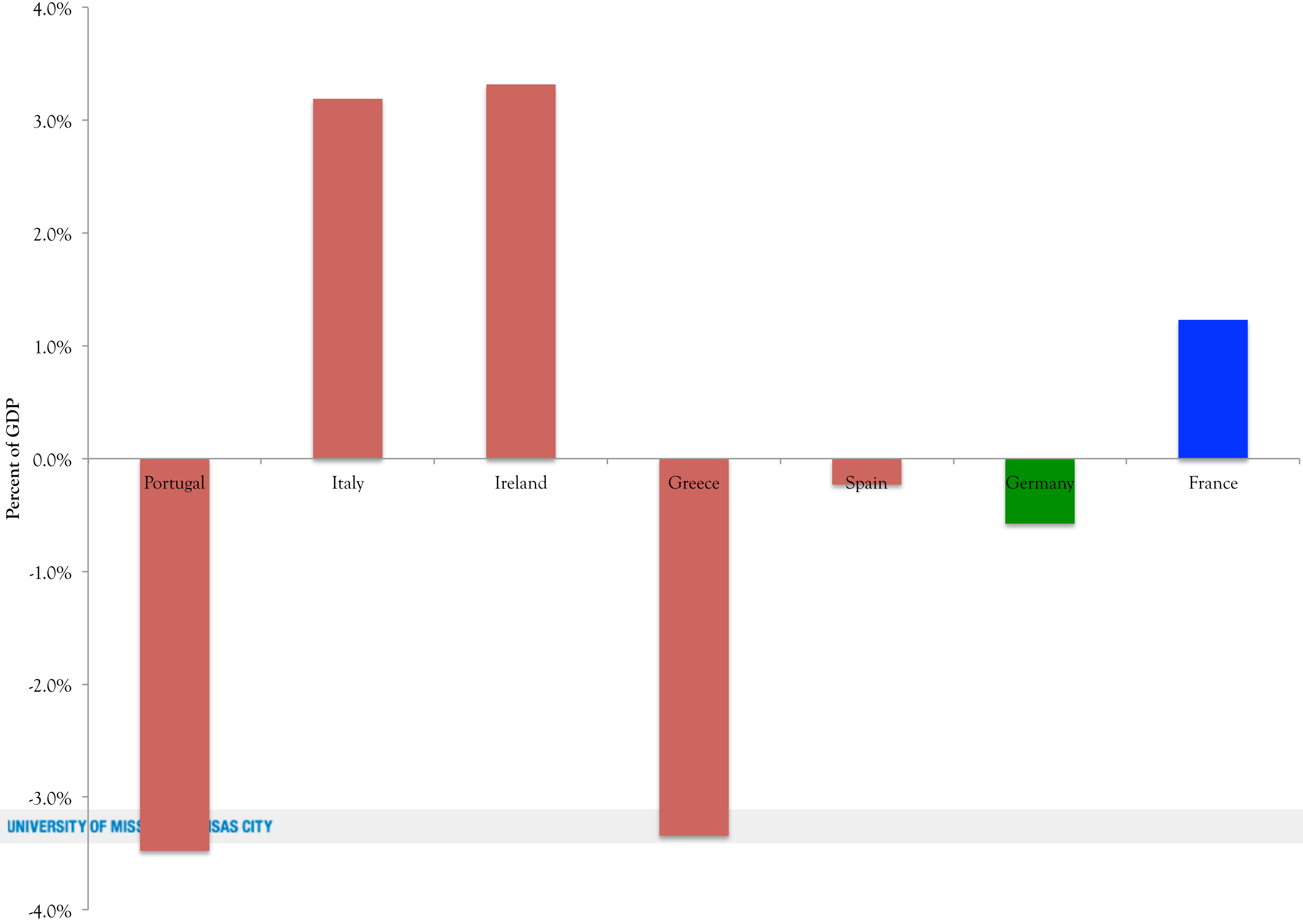
Germany	+41,068
Netherlands	+17,454
Austria	+3,210
Slovakia	+648
AVERAGE	**+12,659**

14 of the EUR-17 run current account **deficits**

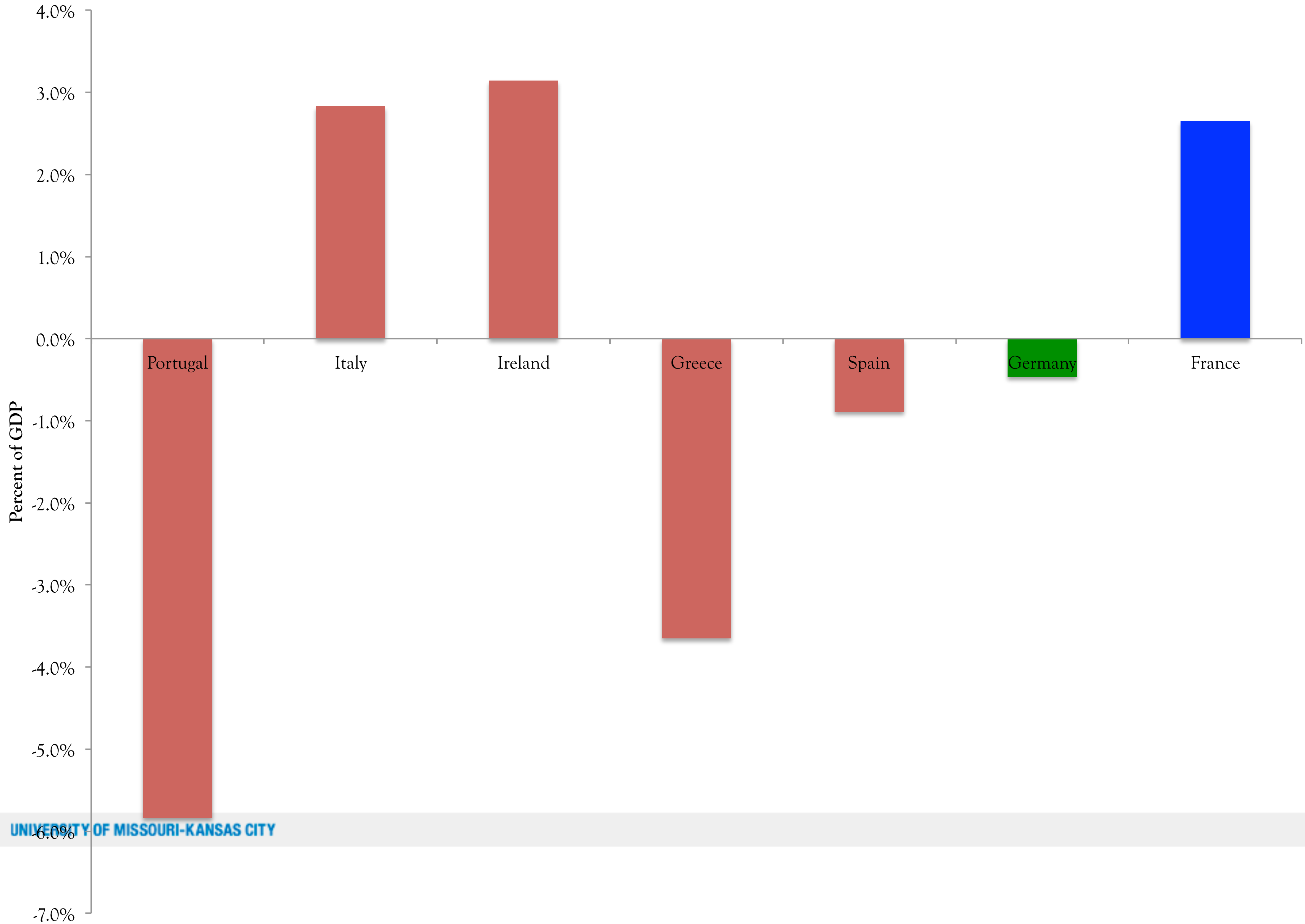
How Germany Crushed the Competition

- The rise of German "competitiveness" began under Chancellor Schroeder in the early 2000s
- The Hartz Commission and then "Agenda 2010"
  - Curtailed the power of labor unions and craft guilds
  - Made it easier for employers to hire/fire at will
  - Cut unemployment benefits so that Germans now receive unemployment benefits for about half as long as an unemployed American

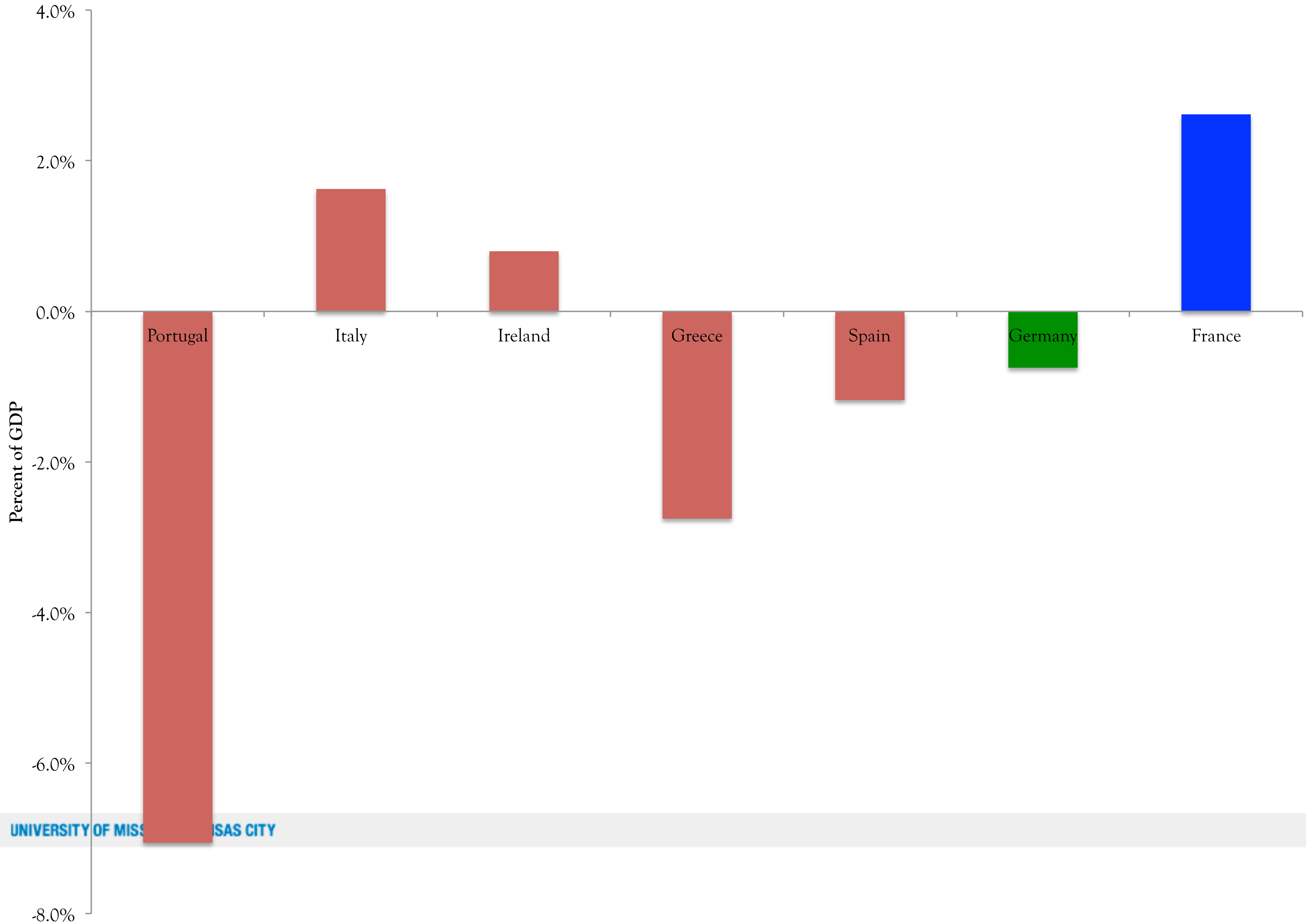
Current Account 1996

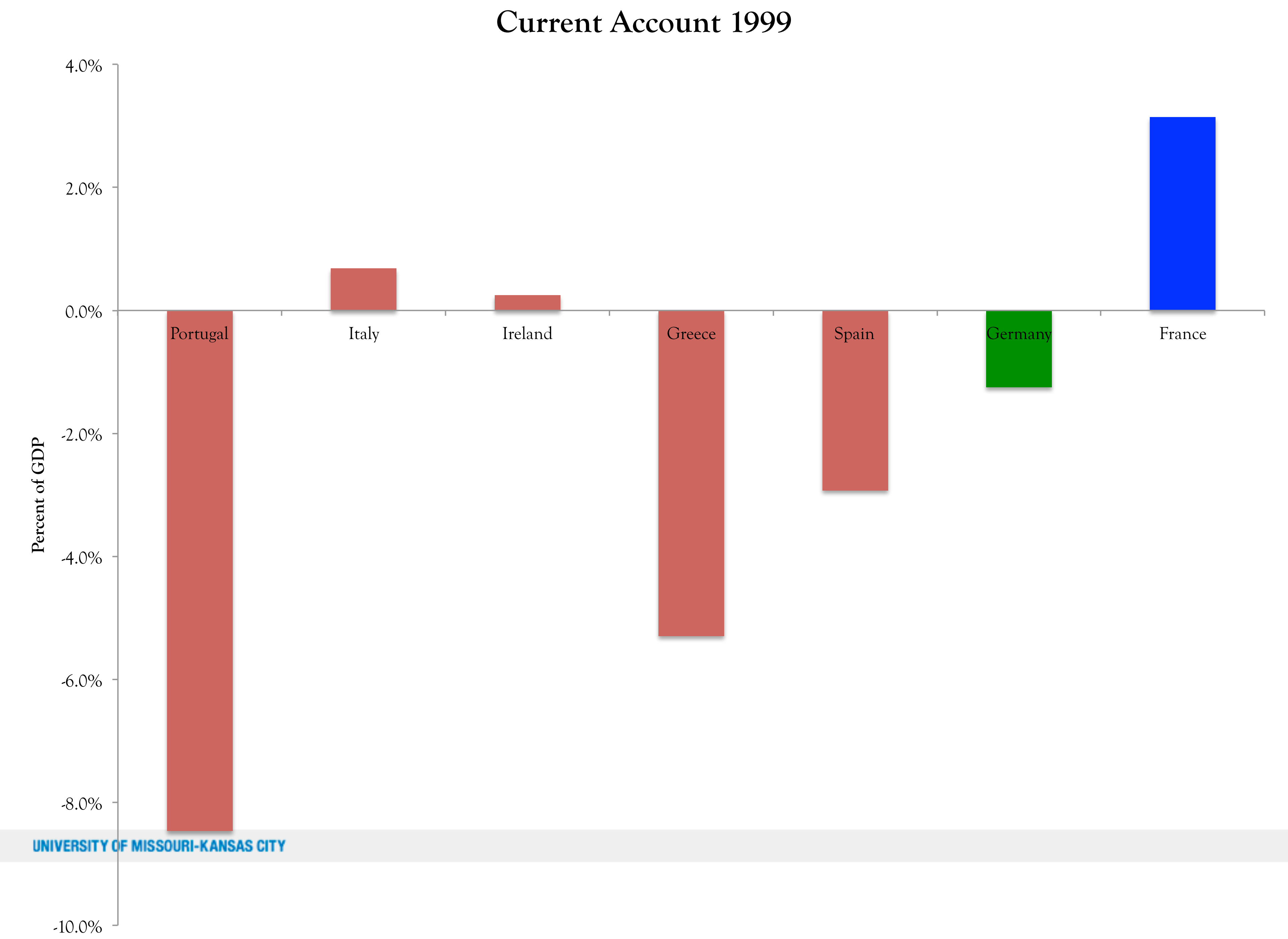


Current Account 1997



Current Account 1998





Current Account 1999
Percent of GDP
4.0%
2.0%
0.0%
-2.0%
-4.0%
-6.0%
-8.0%
-10.0%
Portugal
Italy
Ireland
Greece
Spain
Germany
France
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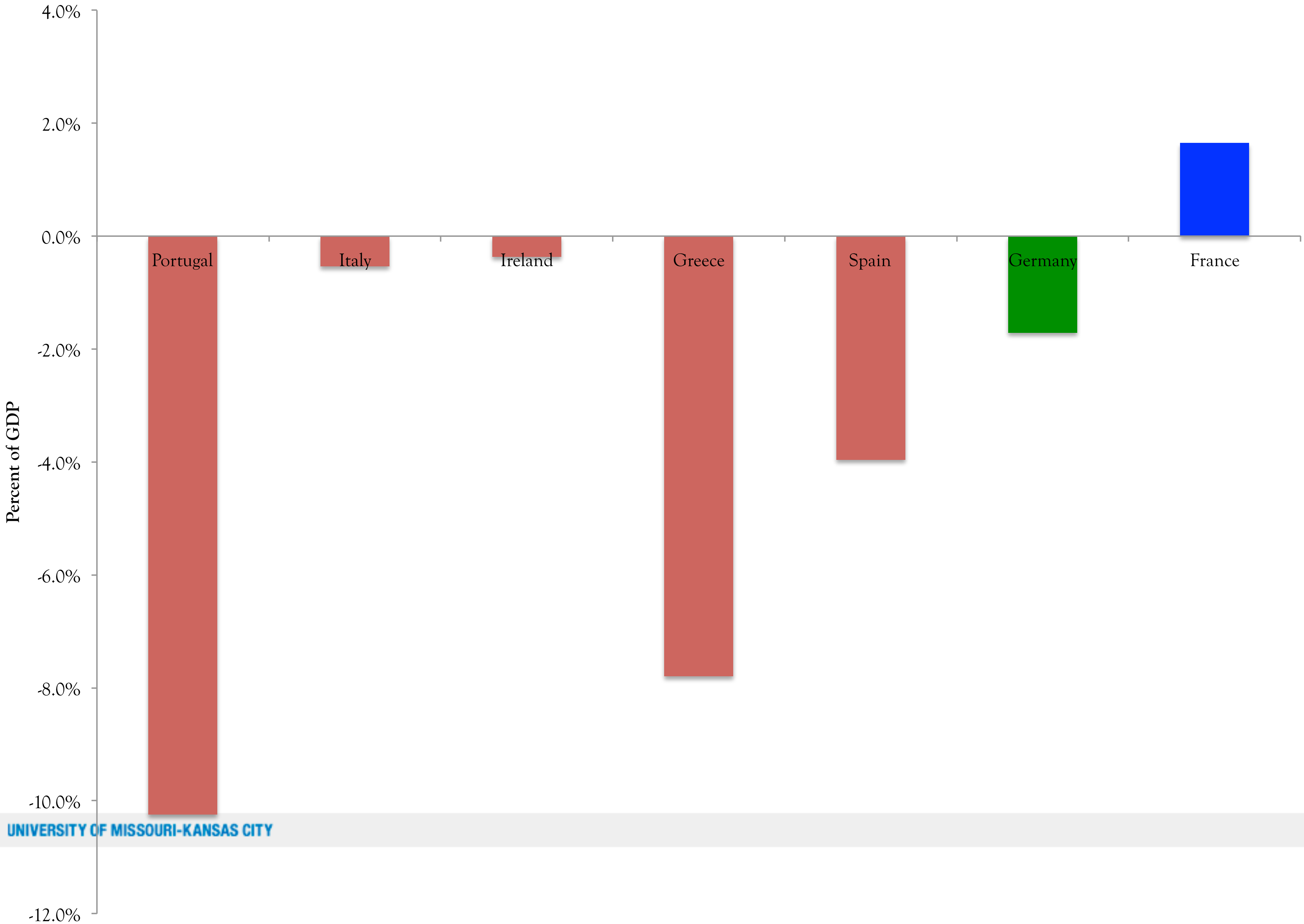
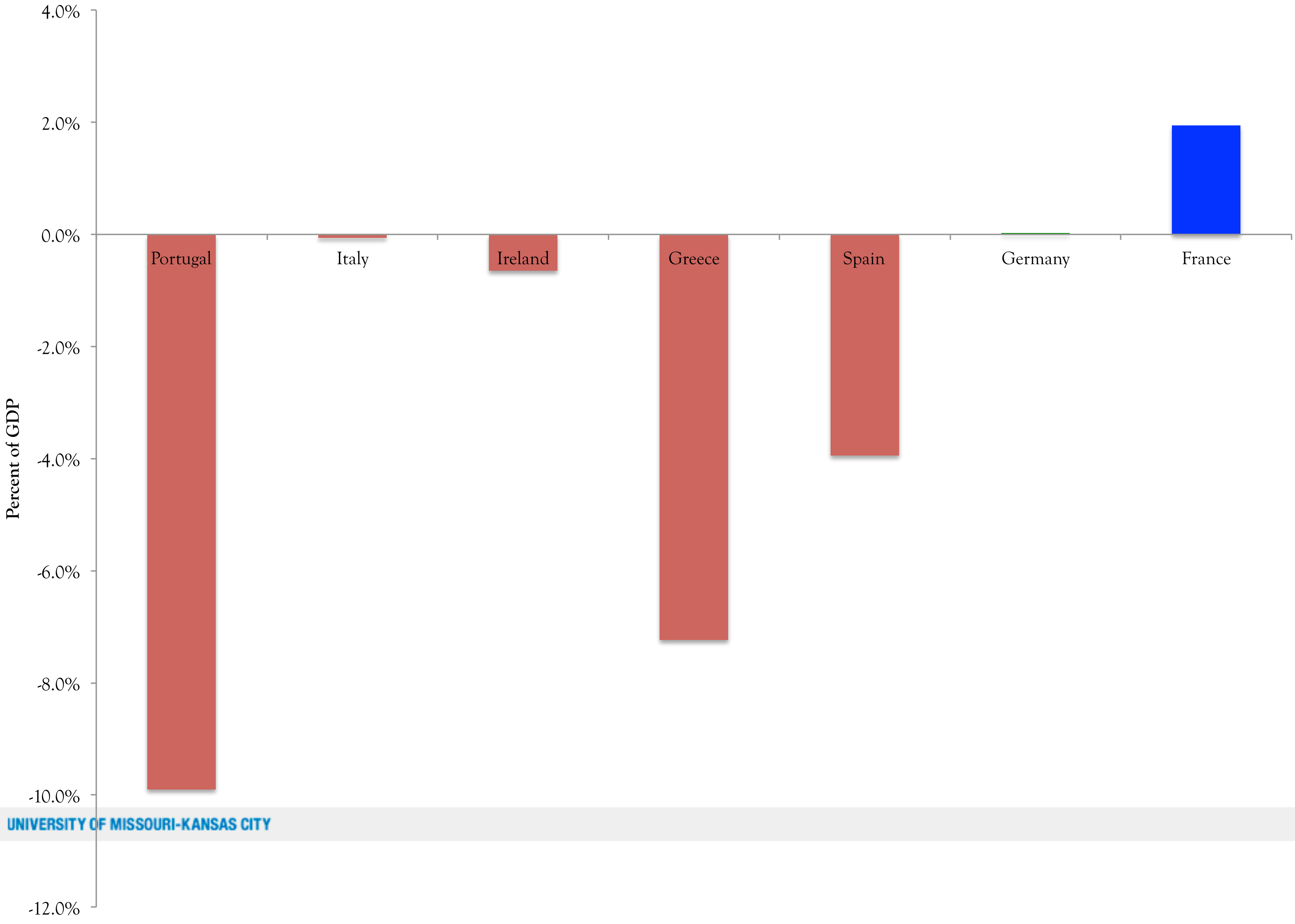
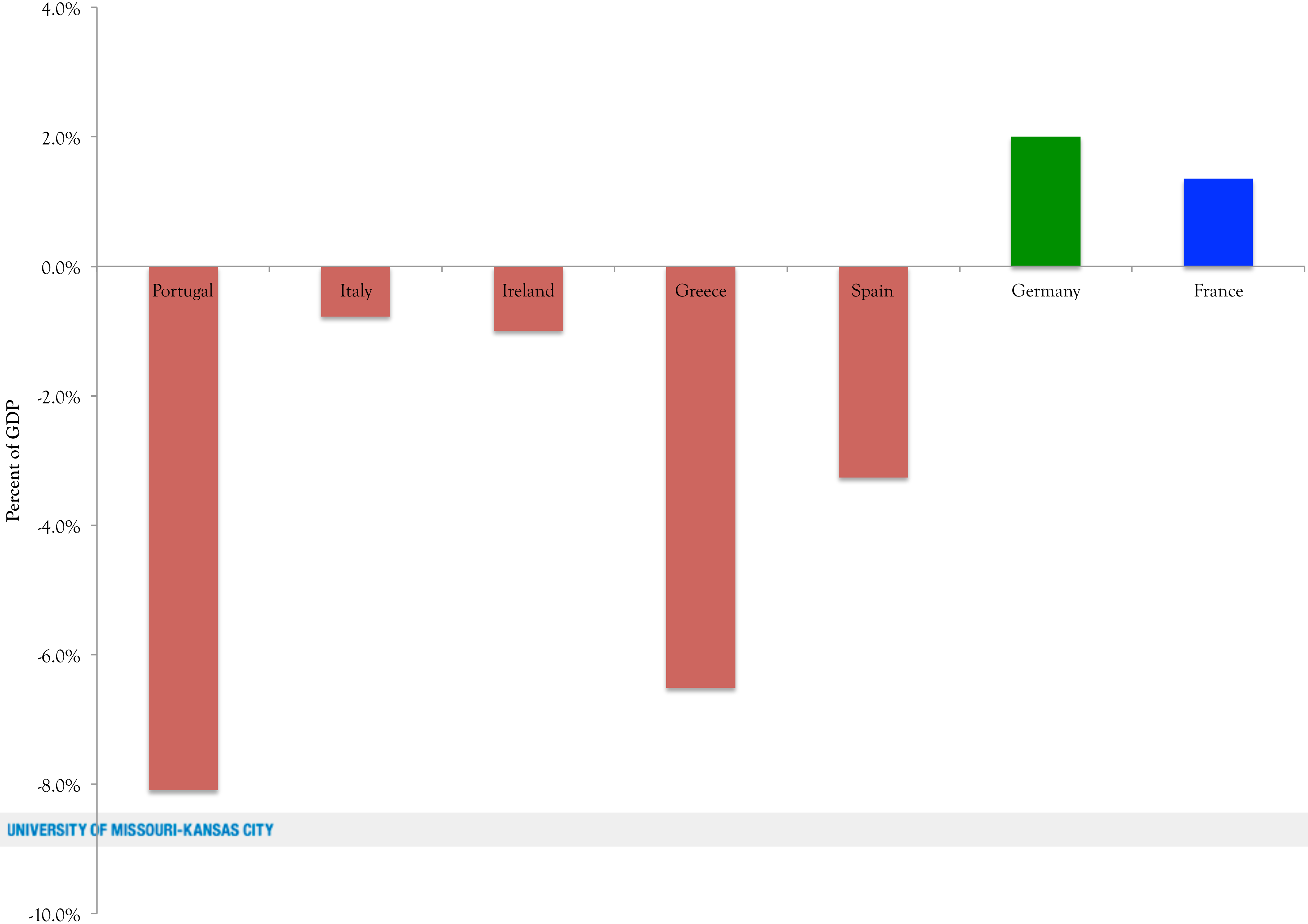
Current Account 2000



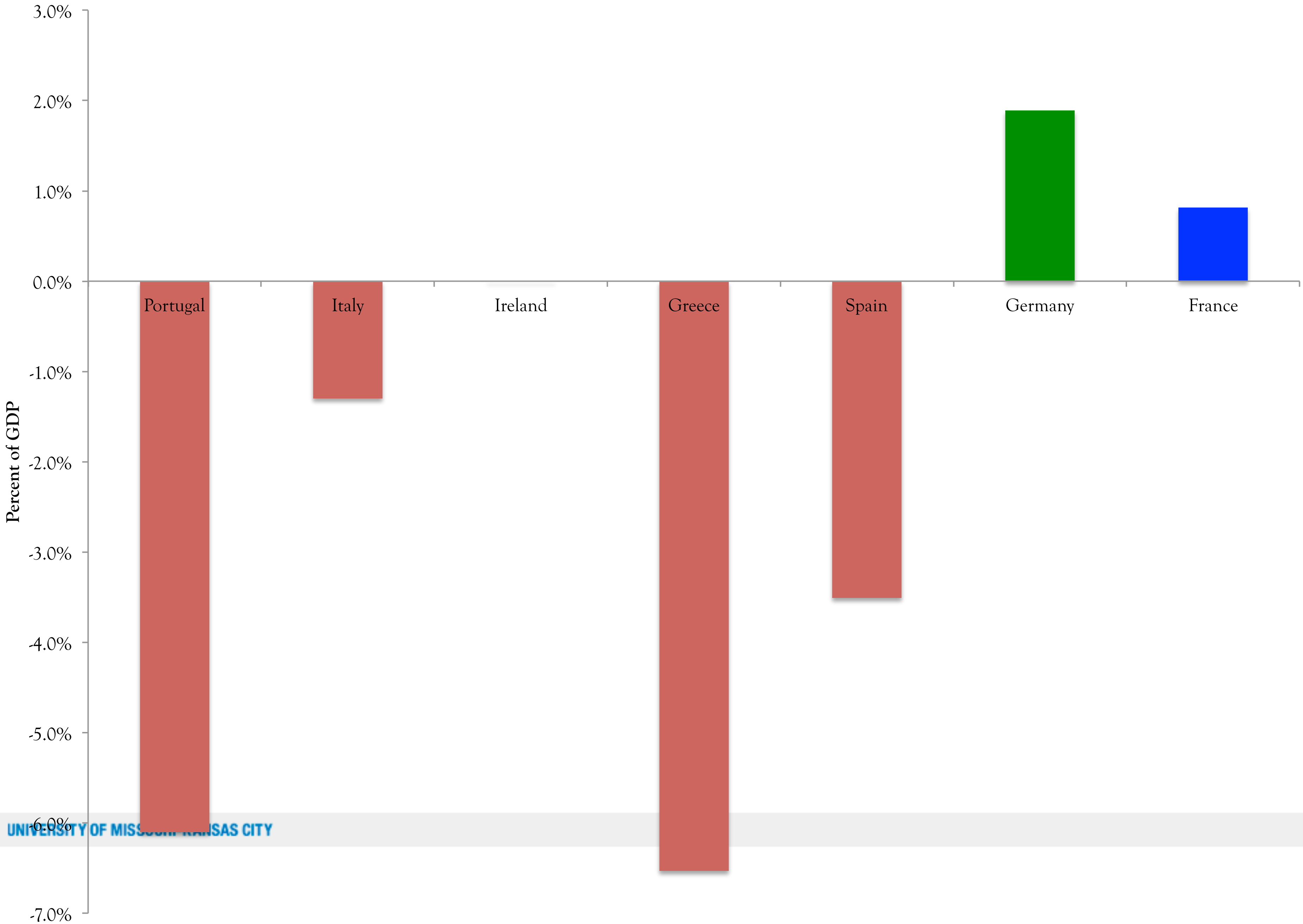
Current Account 2001

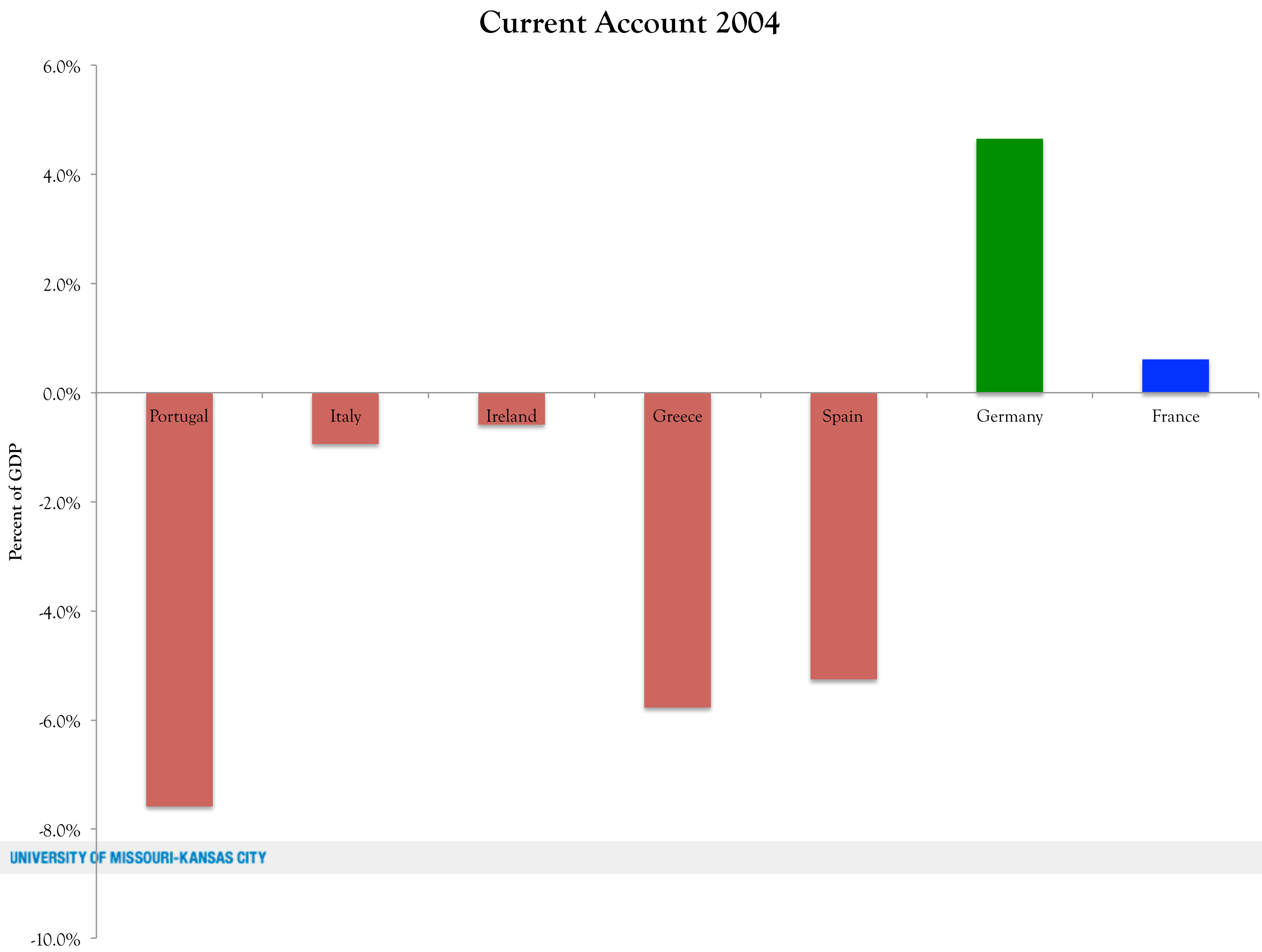


Current Account 2002



Current Account 2003





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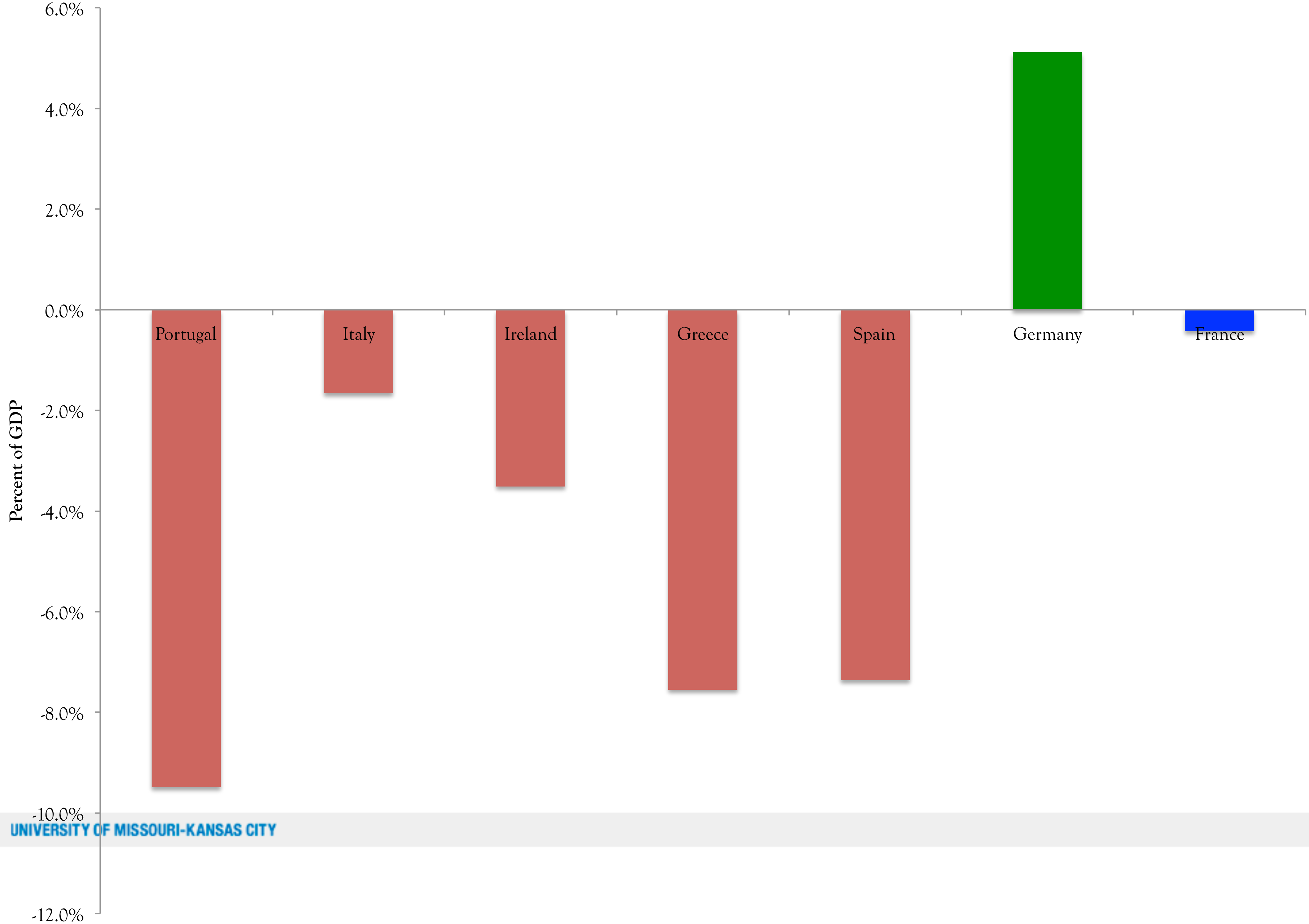
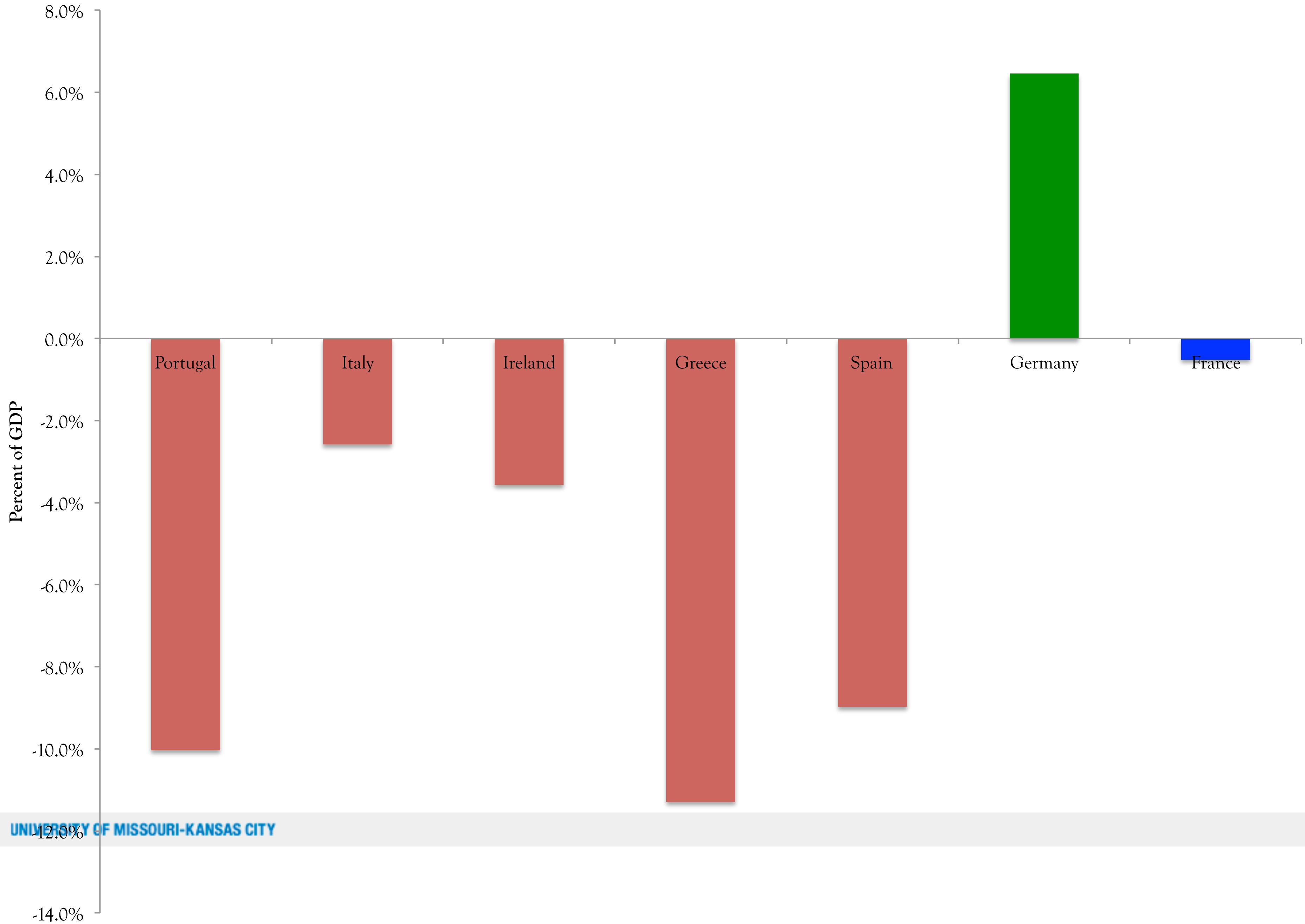
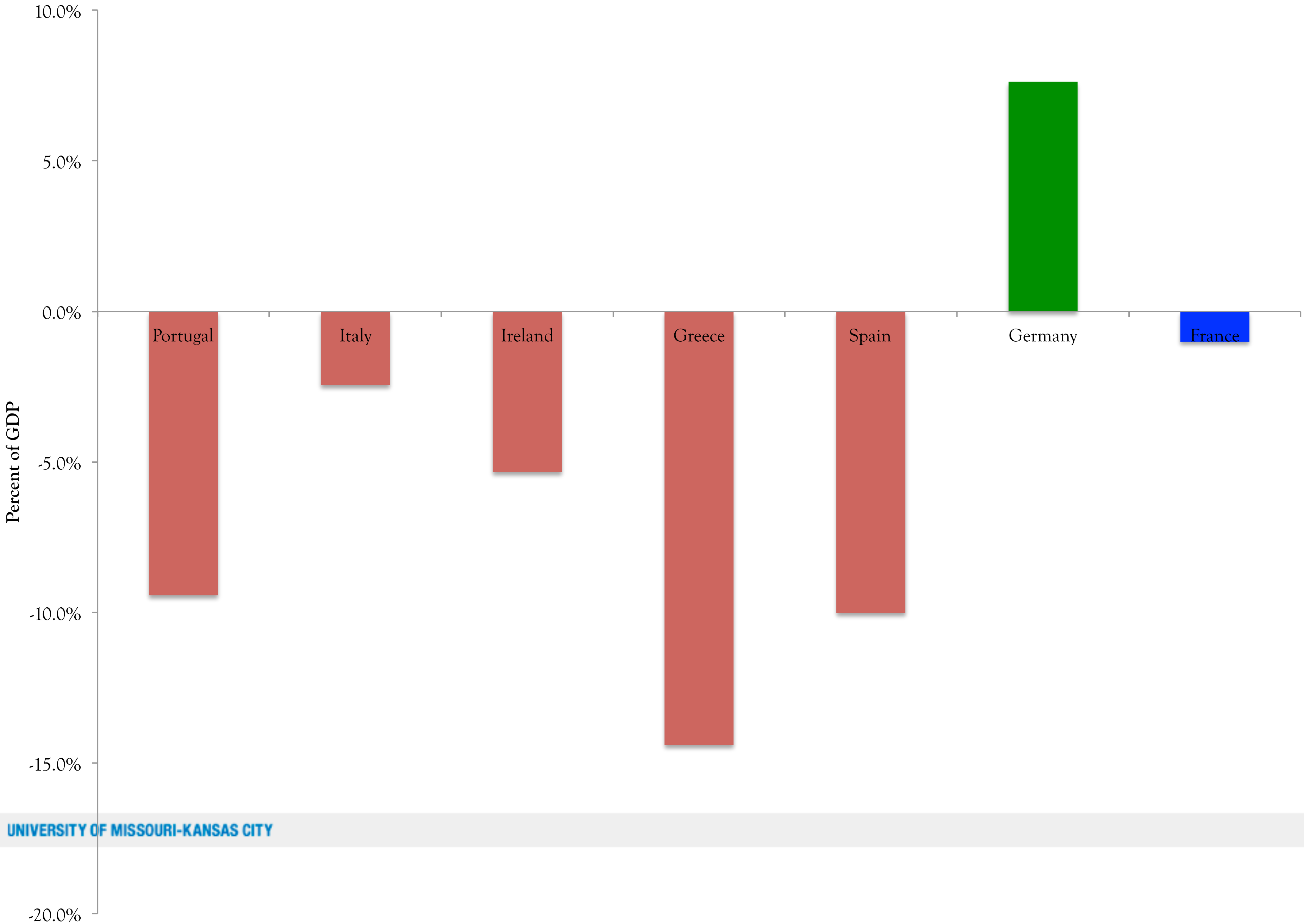
Current Account 2005



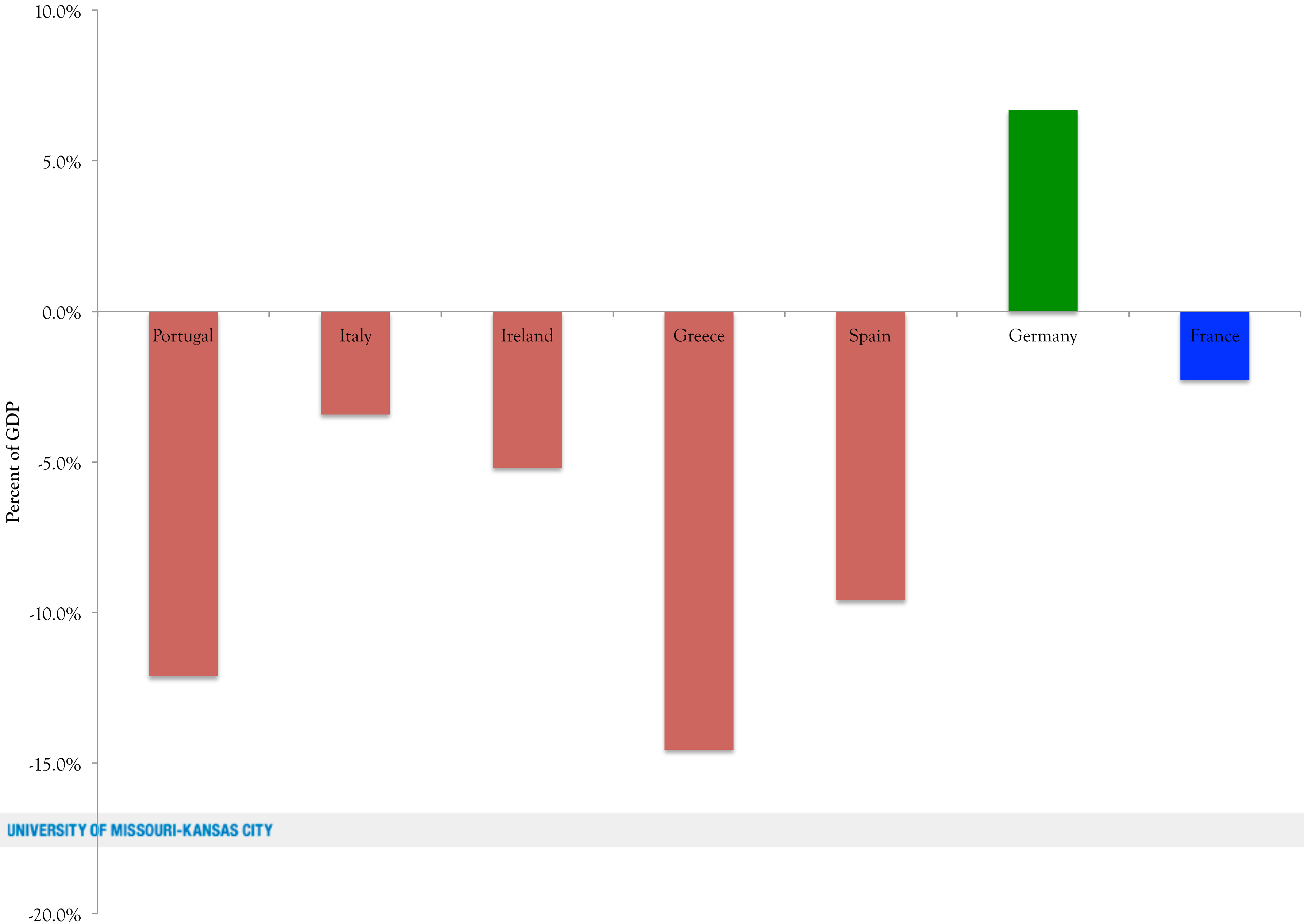
Current Account 2006



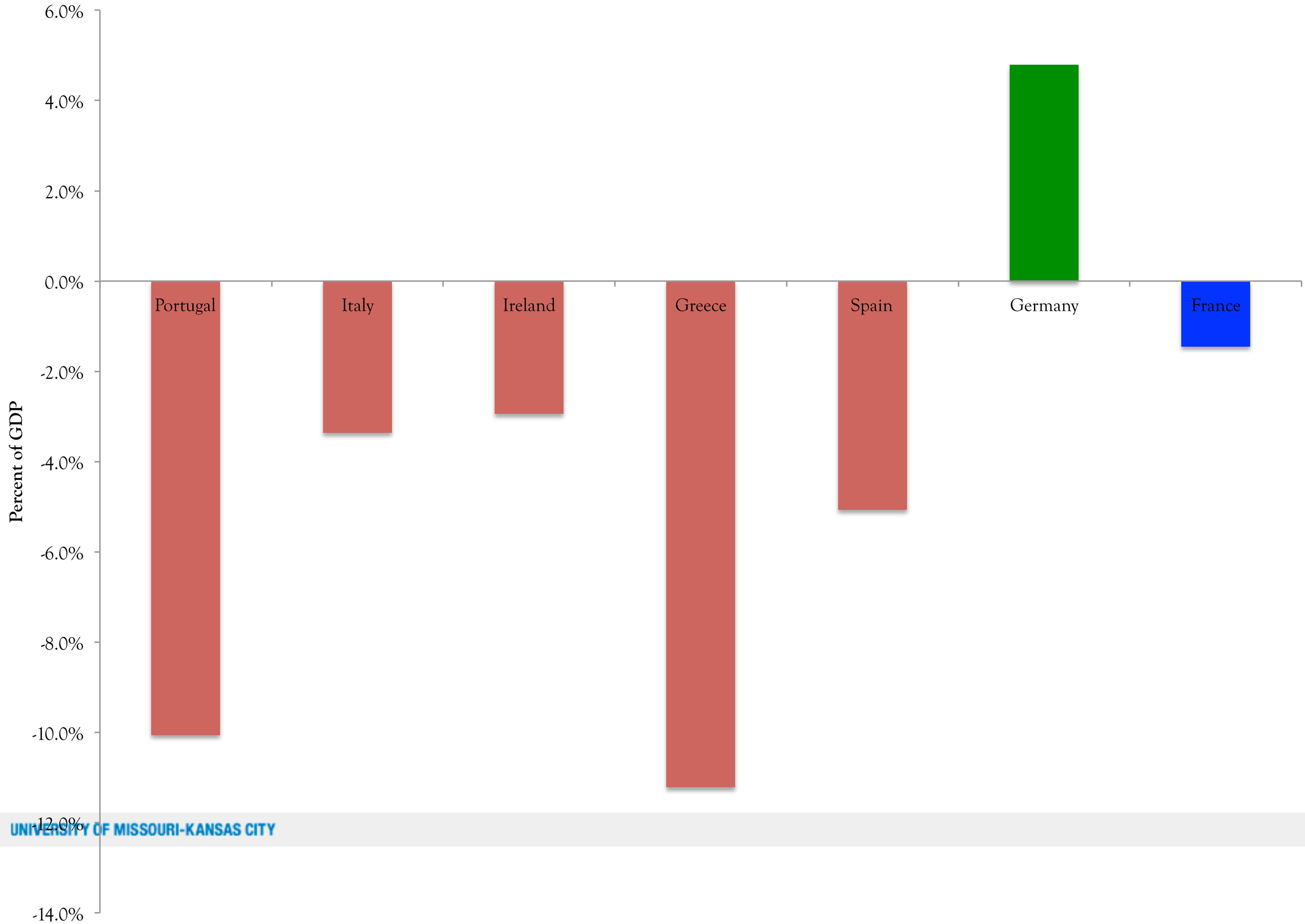
Current Account 2007

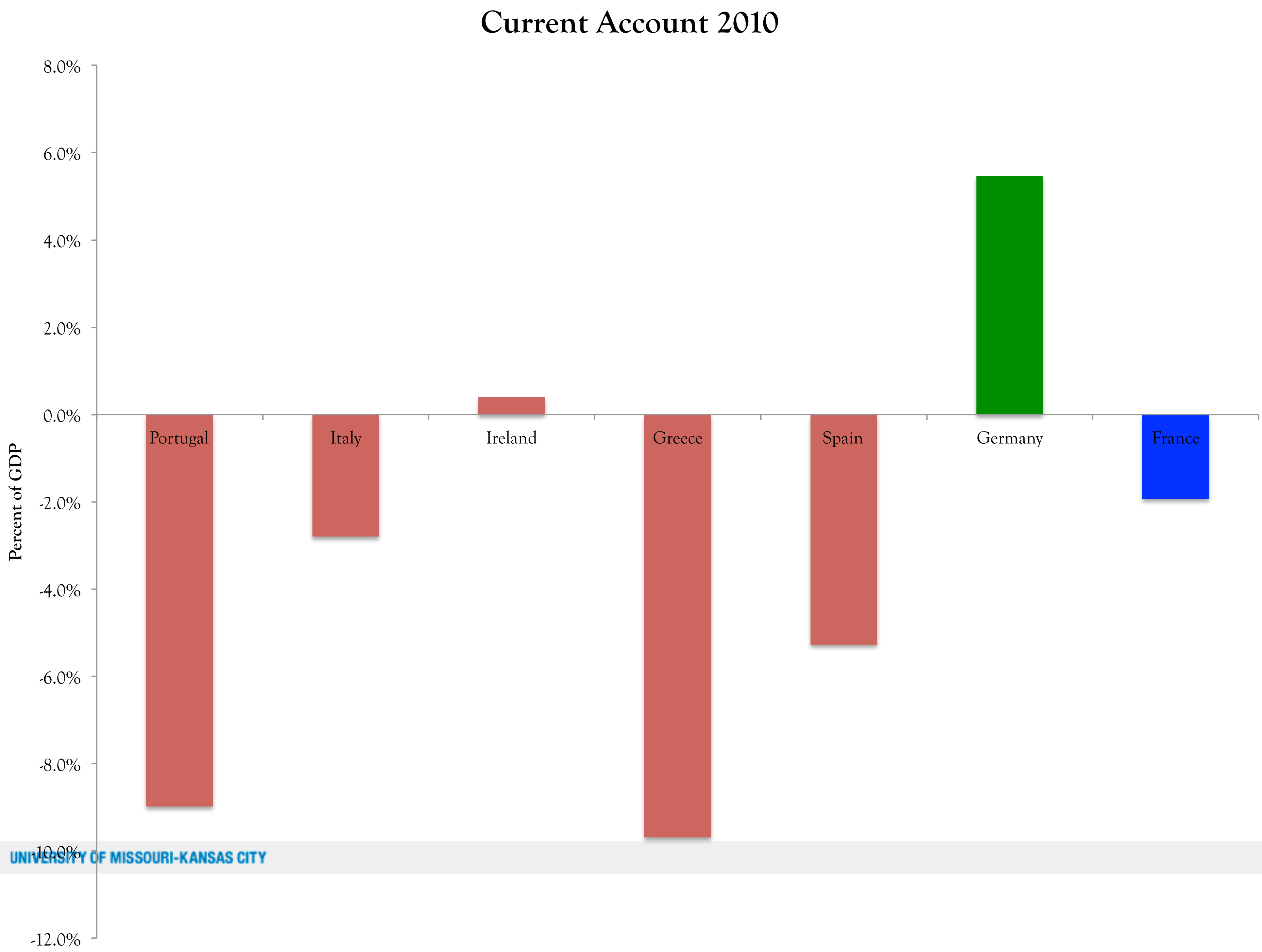


Current Account 2008

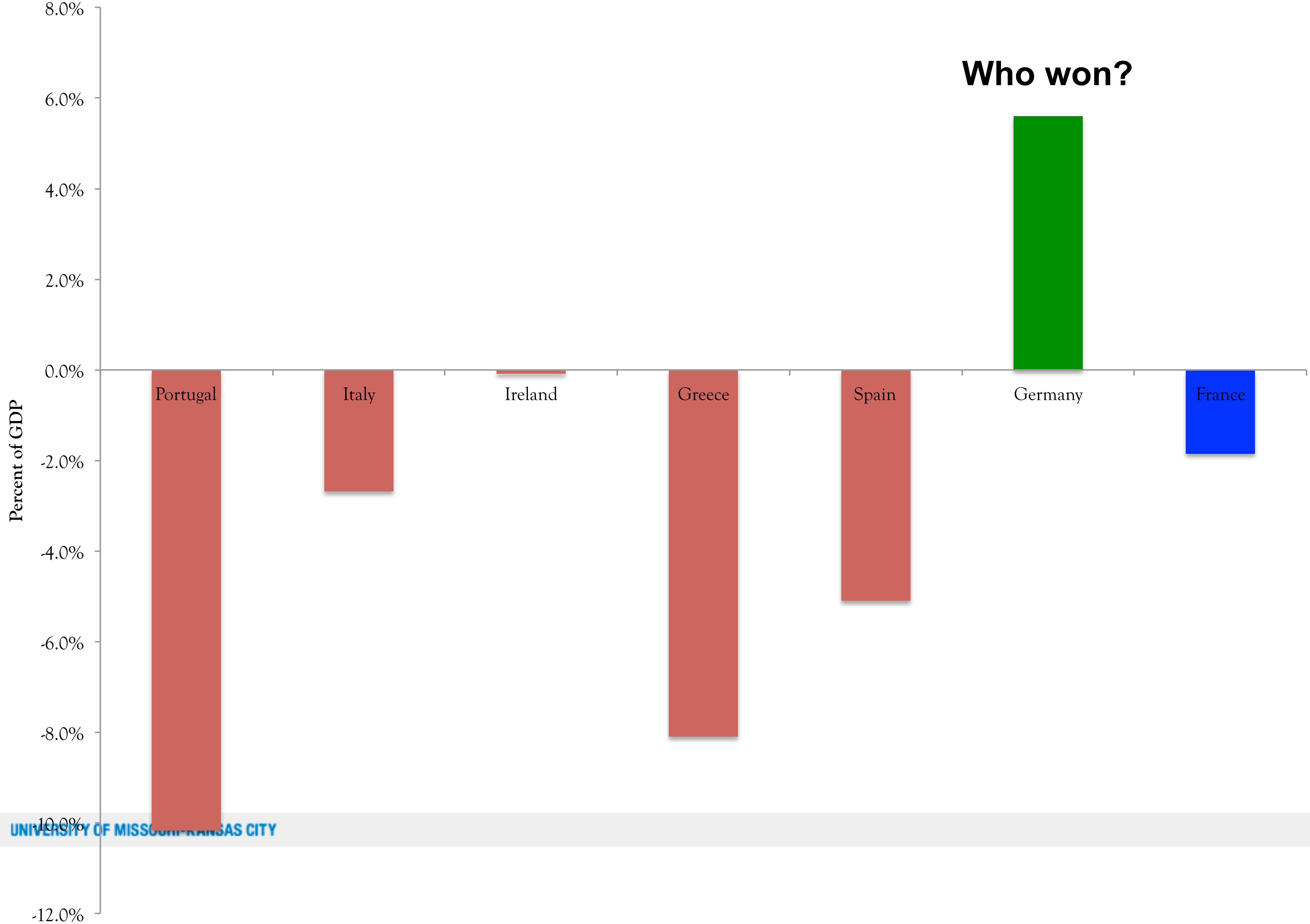


Current Account 2009




Current Account 2010
8.0%
6.0%
4.0%
2.0%
0.0%
-2.0%
-4.0%
-6.0%
-8.0%
-10.0%
-12.0%
Percent of GDP
Portugal
Italy
Ireland
Greece
Spain
Germany
France

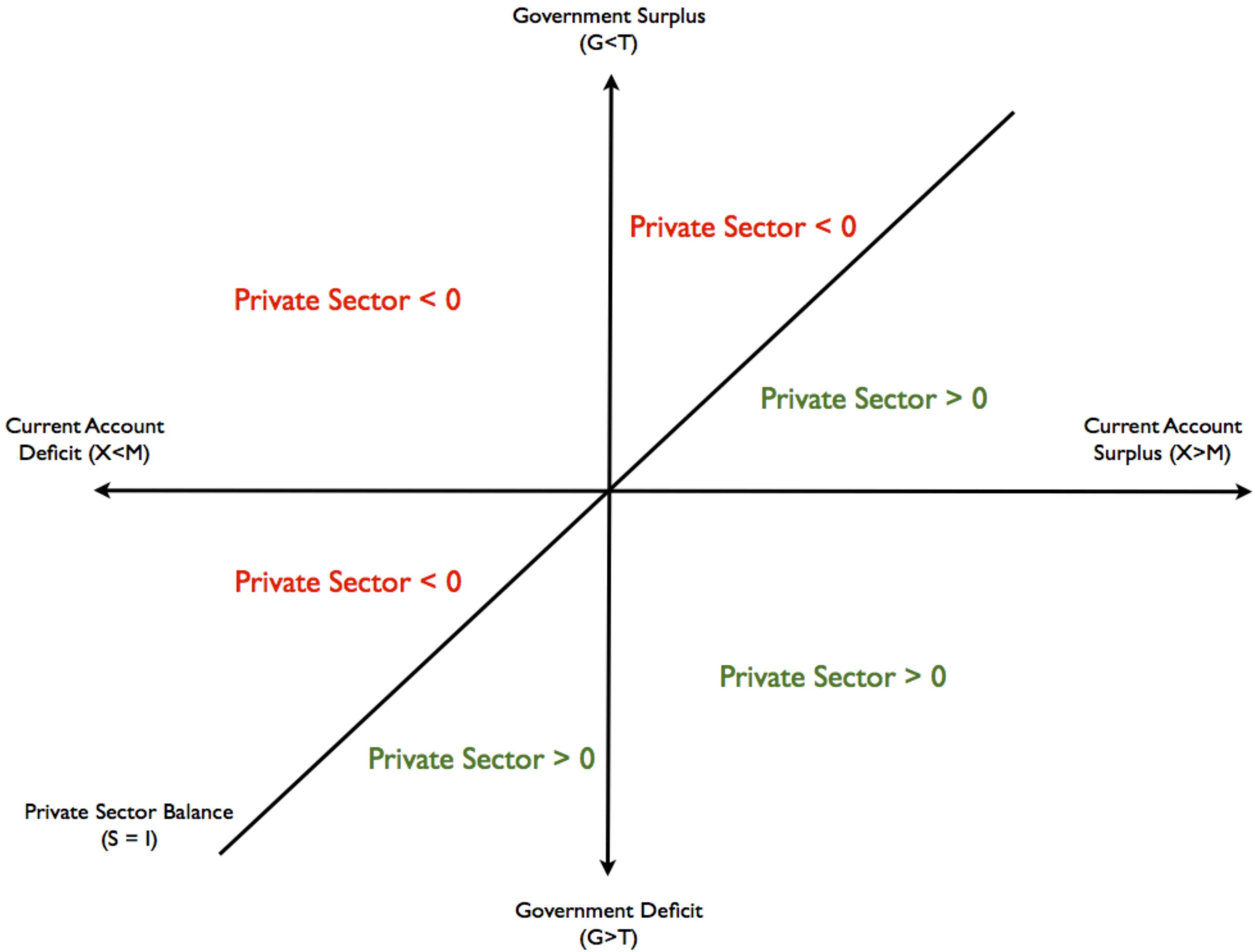
Current Account 2011



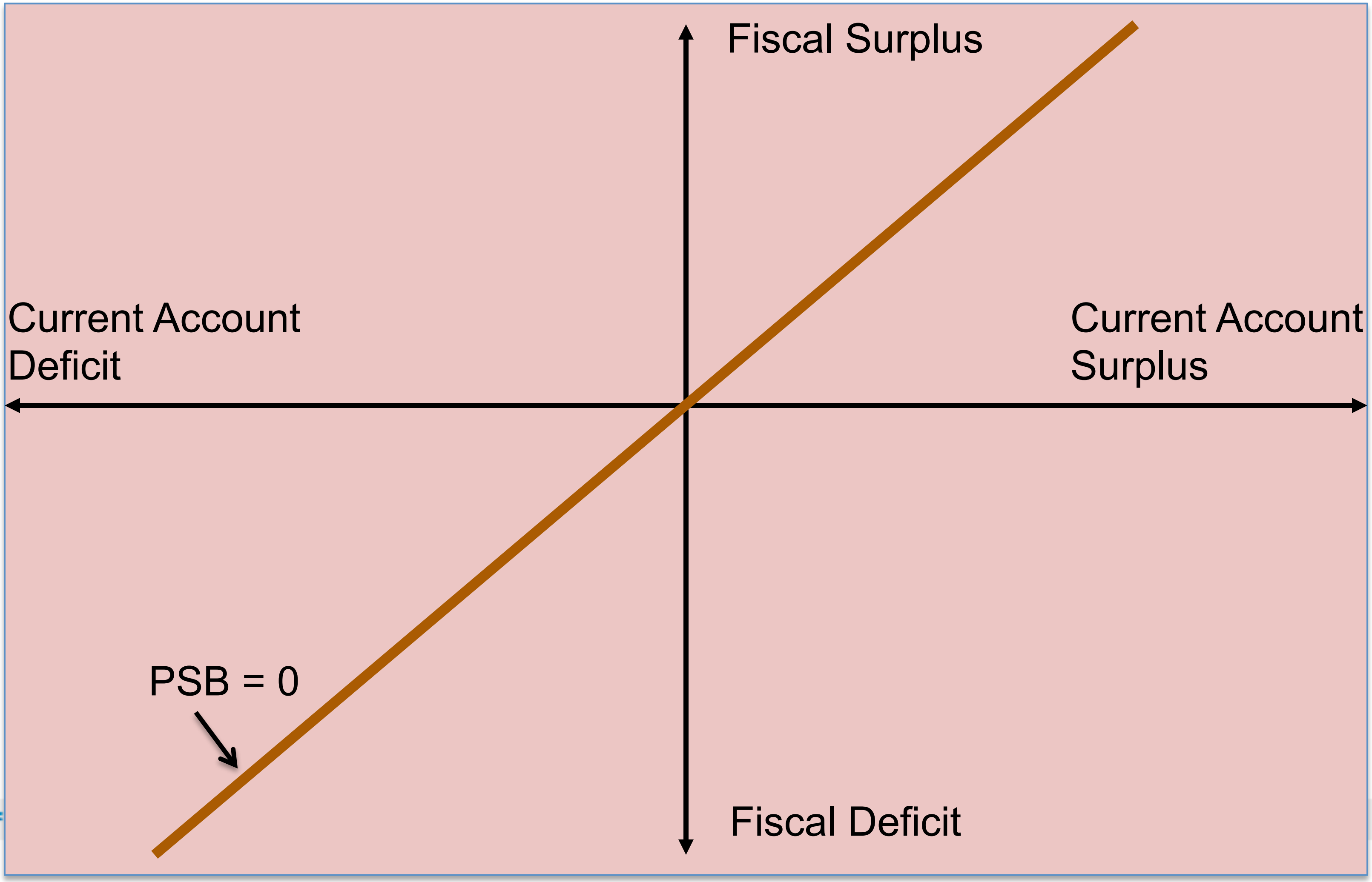
Fiscal Space with EMU

"[T]he power to issue its own money, to make drafts on its own central bank, is the main thing which defines national independence. If a country gives up or loses this power, it acquires the status of a local authority or colony."

~Wynne Godley, 1992


Government Surplus
(G<T)
Private Sector < 0
Private Sector < 0
Private Sector > 0
Current Account
Deficit (X<M)
Current Account
Surplus (X>M)
Private Sector < 0
Private Sector > 0
Private Sector > 0
Private Sector Balance
(S = I)
Government Deficit
(G>T)

Permissible Space for Sovereign Issuers



May Face Self-Imposed Constraints

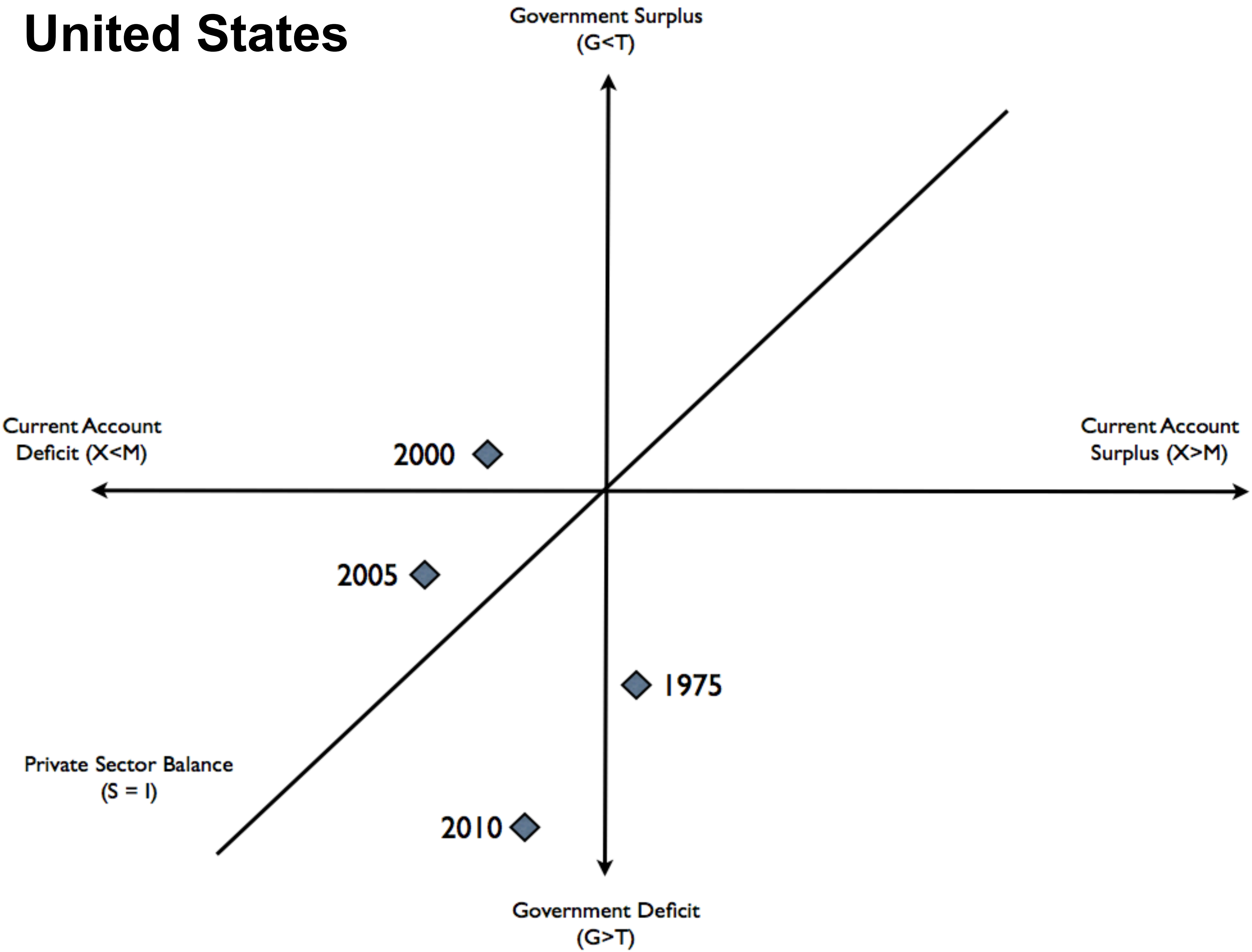
- Debt ceiling
- No overdraft rule
- Fed cannot buy directly

There are No "Market" Constraints

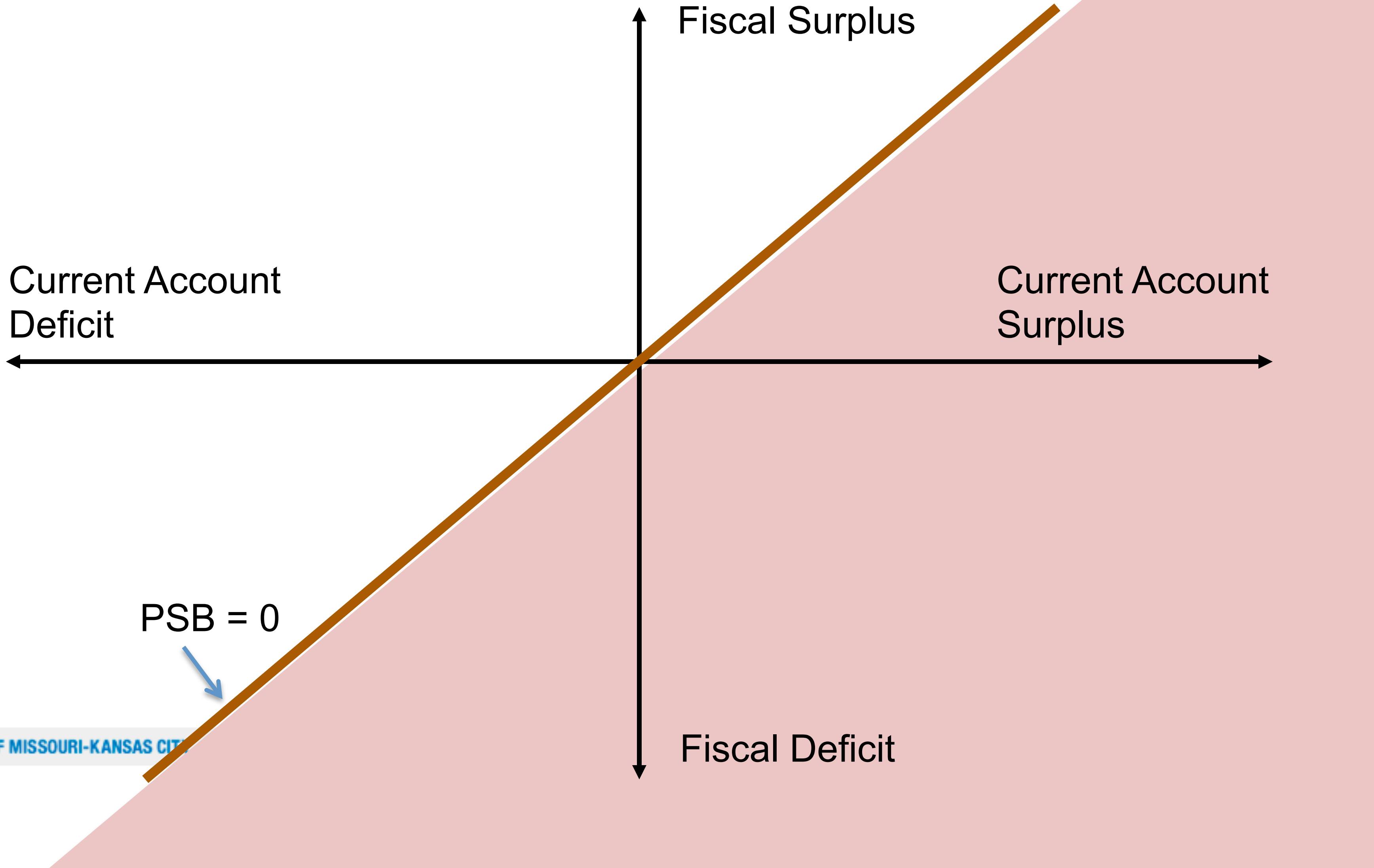
"The treasury can always raise money by issuing securities. The bond vigilantes really have it backwards. There is always more demand for treasuries than can be allocated from a limited supply of new issues in each auction; the winners in the auctions get to place their funds in the safest most liquid form of instrument there is for US dollars; the losers are stuck keeping some of their funds in banks, with bank risk."

~Frank N. Newman, 2013

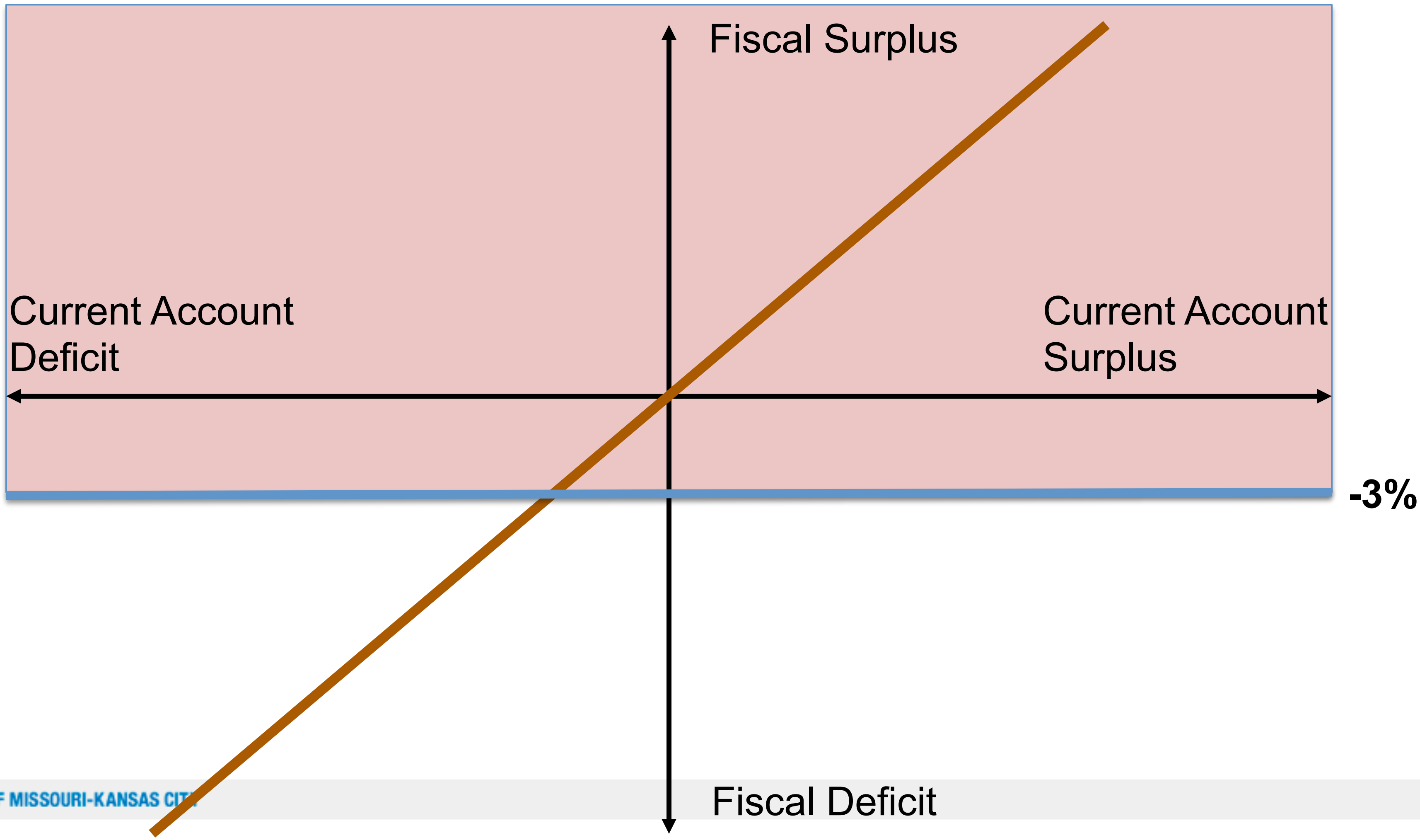
United States



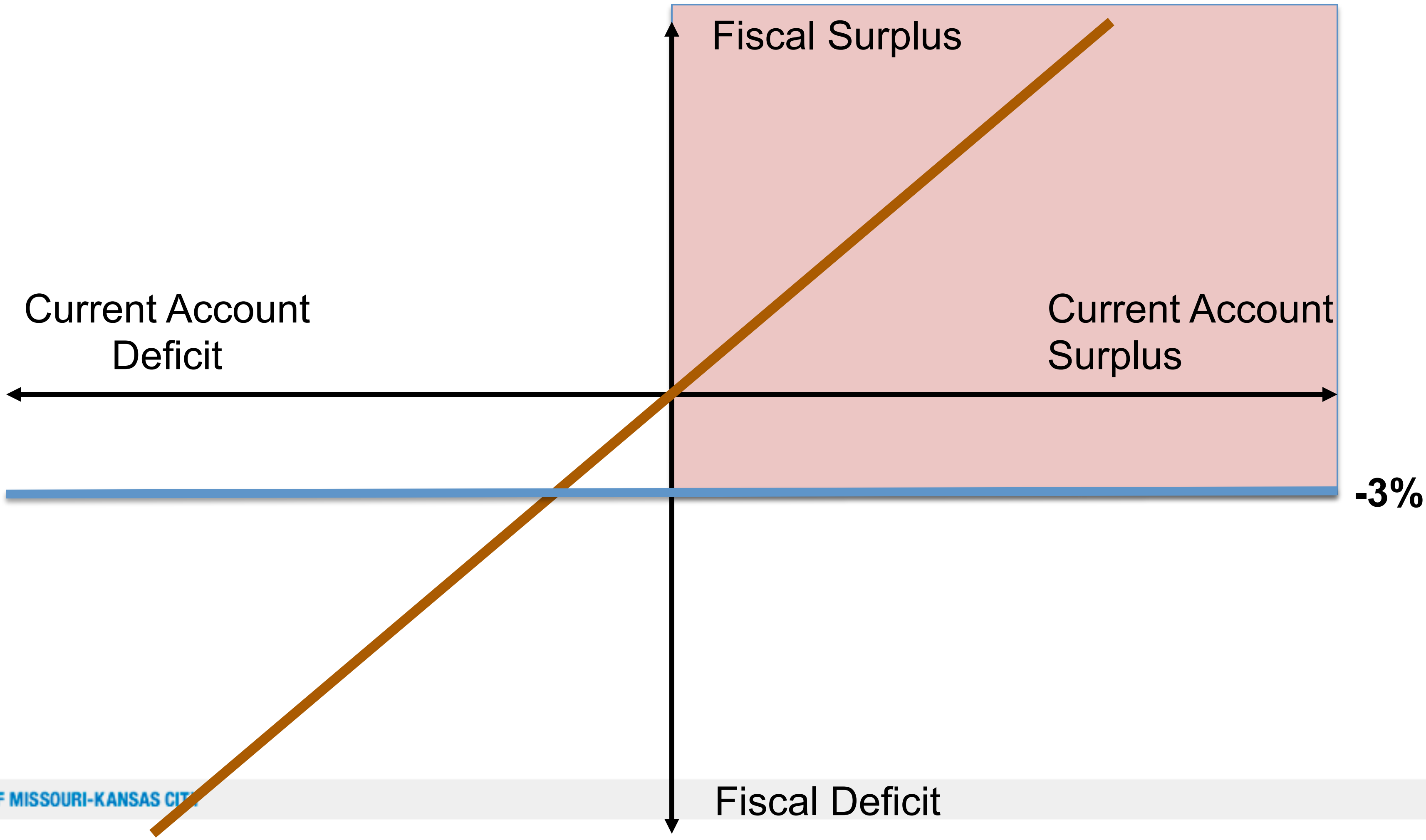
Sustainable Space for Sovereign Issuers



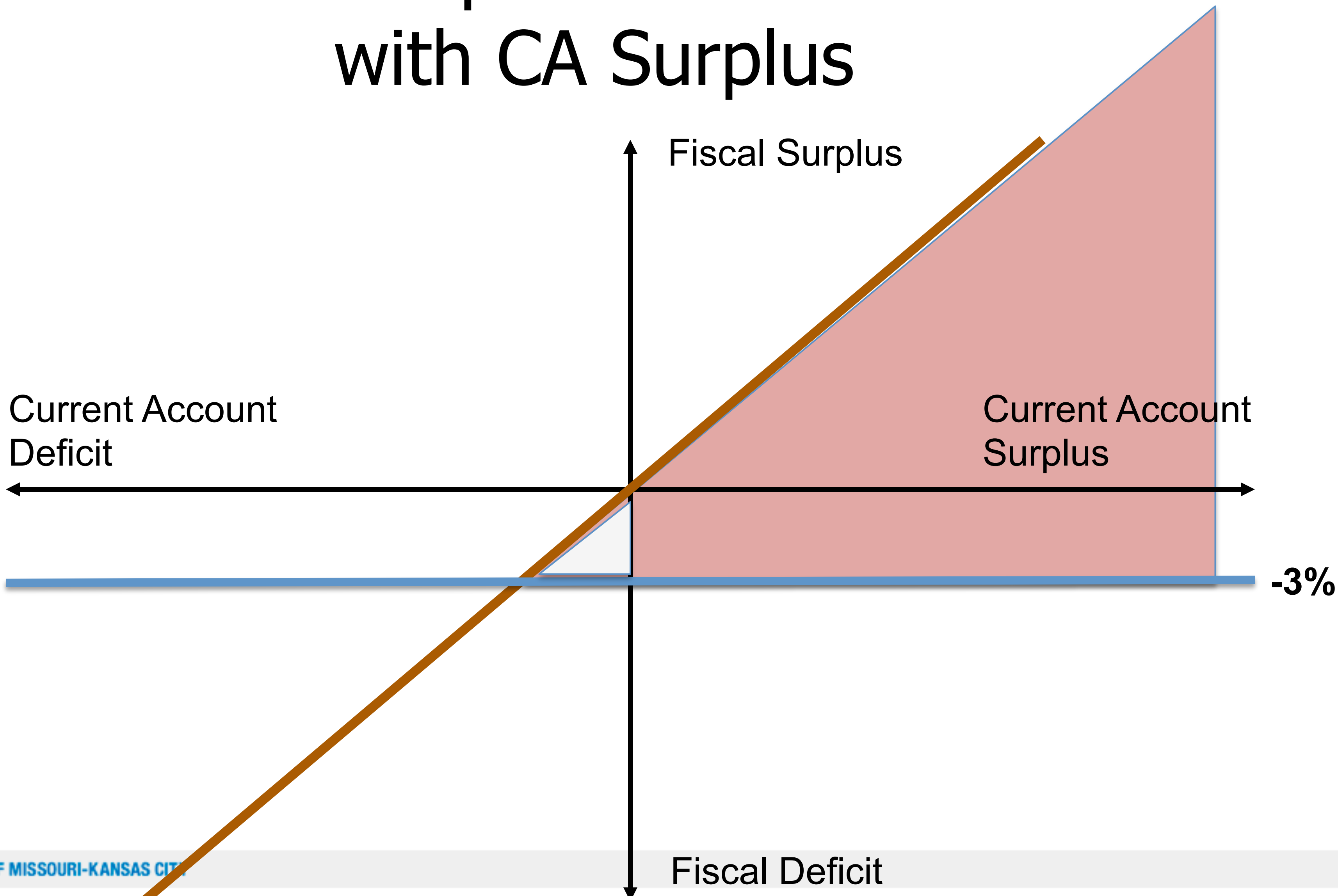
Permissible Space Under Maastricht



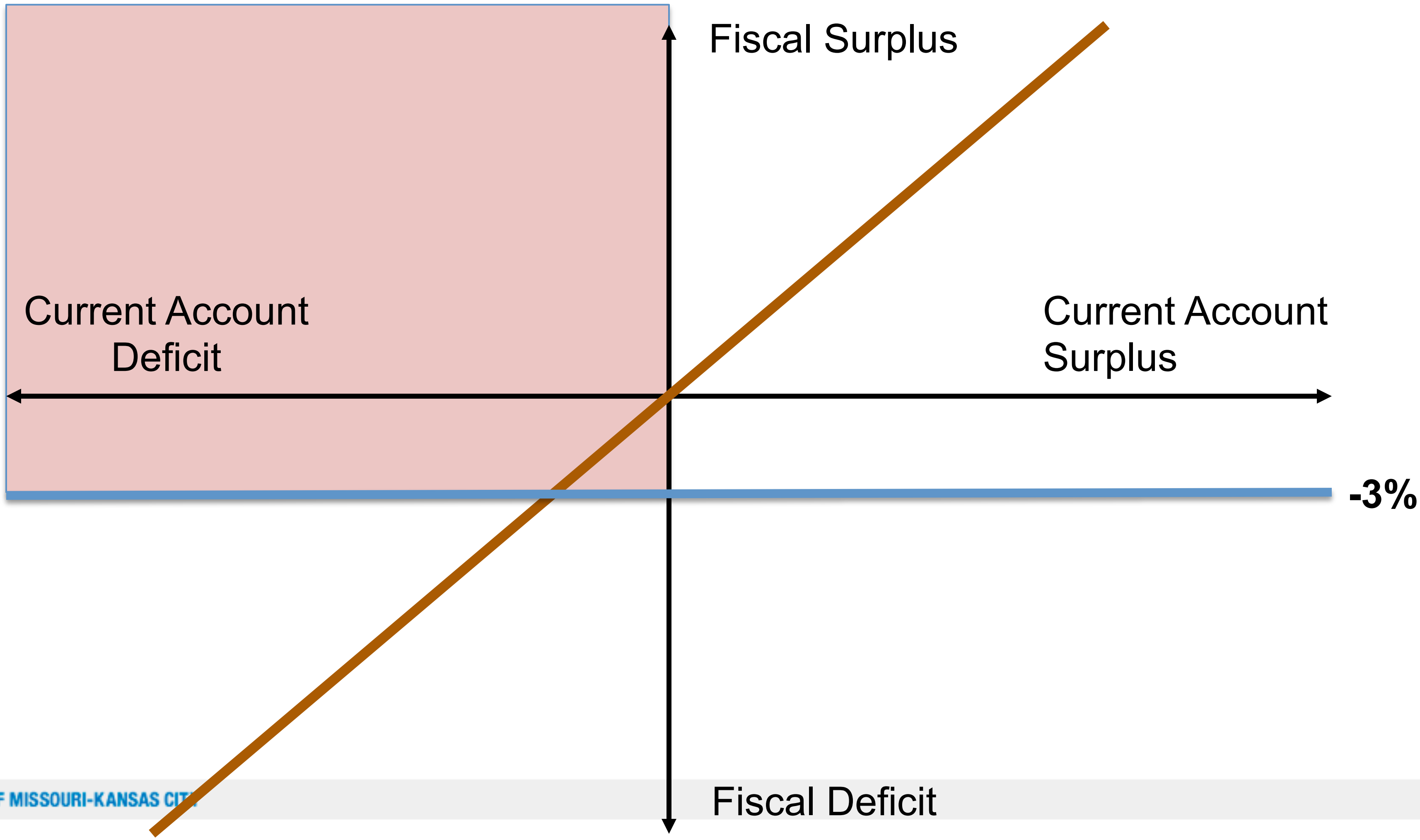
Possible Space for EMU Nations with CA Surpluses



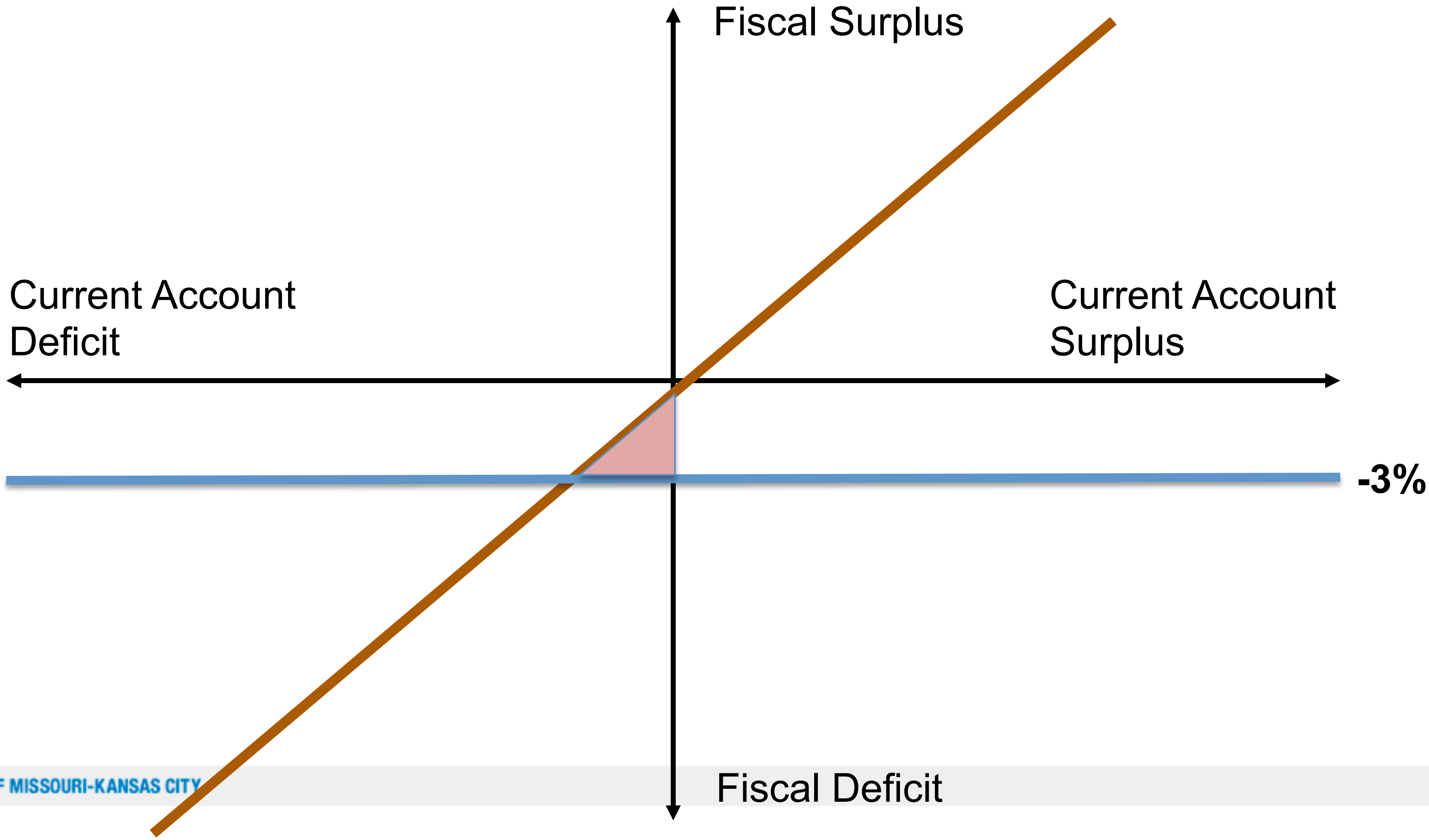
Sustainable Space for EMU Nations with CA Surplus



Possible Space for EMU Nations with CA Deficits



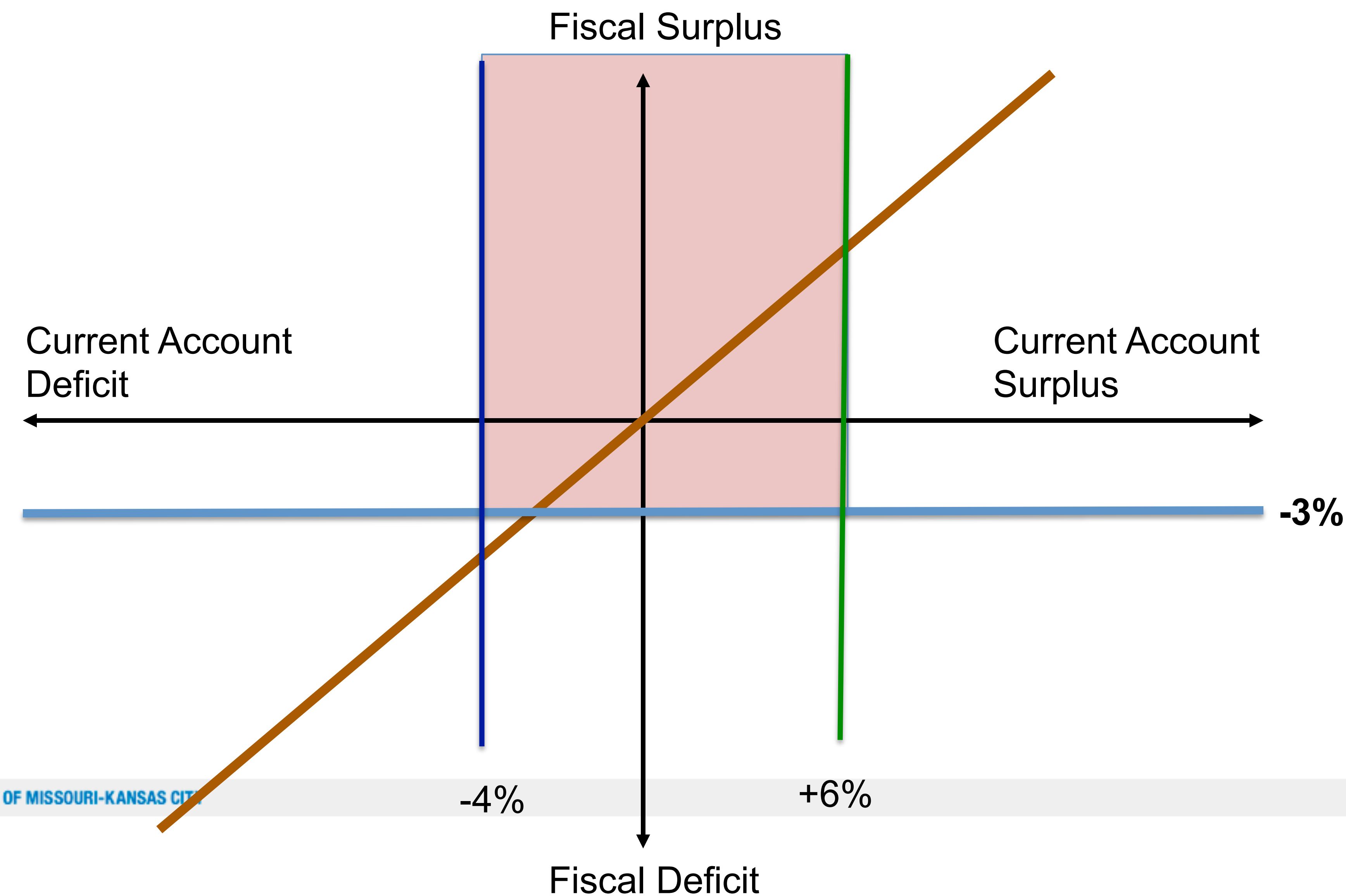
Sustainable Space for EMU Nations with CA Deficits



The German Problem

- Germany's CA surpluses are increasingly viewed as problematic
- Projected to exceed 6% of GDP this year
- Soros insists that the EZ cannot hold together as long as countries are "divided into two classes"
- The European Commission now issues a *Macroeconomic Imbalance Scorecard*
  - Includes a 6% threshold on current account surpluses
  - Threshold on deficits is 4%
  - Possible penalties for exceeding these targets

Permissible Space With Scorecard Rules



"In a sense, the budget deficit can be considered an artificial surplus."

~Michael Kalecki

Implications?

- "If the Eurozone is to survive, it must become a transfer union. And rather soon." (Alvarez, 2012)
- Germany must help countries regain competitiveness (Soros, 2012)
- "The only way out of this predicament is to shift to domestic demand-led development strategies" (Kregel, 2010)
- "Allowing prices and wages to adjust downward will not restore employment and growth" (Terzi, 2010)

Bottom Line

- The US, UK, Japan, Canada, etc. enjoy a degree of fiscal space that is not available to most countries in the Eurozone
- Government budget constraints – as usually conceived – are not inapplicable
- Market discipline is a real thing
- One way or another, policy must ensure that private sector balance are almost always in (+)

Thank You!

Godley Believed ...

"I think that the central government of any sovereign state ought to be striving all the time to determine the optimum overall level of **public provision**, the correct overall **burden of taxation**, the correct **allocation of total expenditures** between competing requirements and the just **distribution of the tax burden**."

~Wynne Godley, 1992

Godley Asked ….

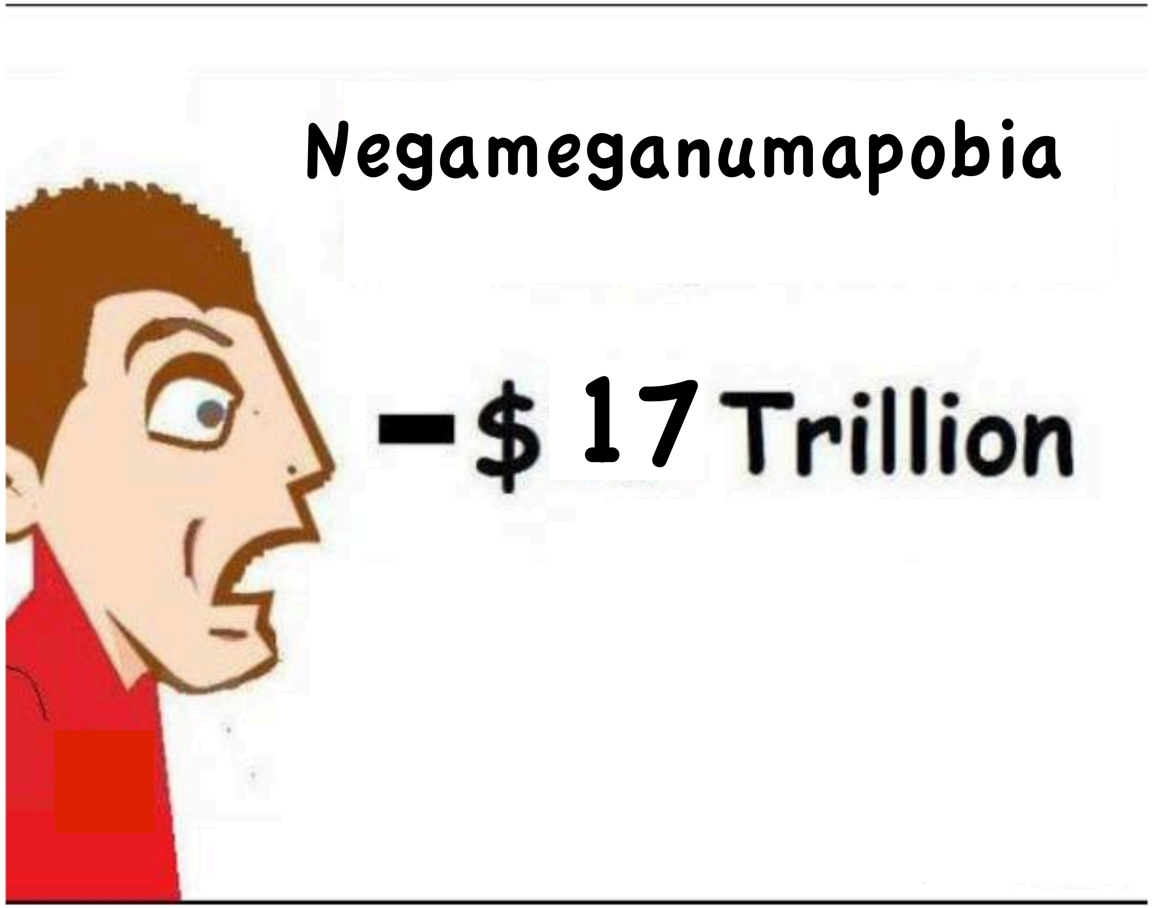
"But how is the rest of economic policy to be run? As the treaty proposes no new institutions other than a European bank, its sponsors must suppose that nothing more is needed. But this could only be correct if modern economies were self-adjusting systems that didn't need any management at all."

~ Wynne Godley, 1992

But the Wrong Bird Brains are In Charge

- Spain just unveiled its 5th austerity package in a year
- Includes €20bn in *extra* cuts
- Goal is
- to reduce deficit-to-GDP to 4.5% next year
- Precisely the wrong policy
- Kalecki: "In a sense, the budget deficit can be considered an artificial surplus."
- As all deficit owls understand

END


Negameganumapobia
-$ 17 Trillion

Verakoufis & Holland: A Modest Proposal

- End the disintegration of the EZ banking system
  - Capital flight pushed stricken banks in Spain and Italy into a death spiral, made worse by austerity
  - The task of recapitalizing Europe's banks must be shifted directly to the European Financial Stability Facility under supervision of the ECB

Verakoufis & Holland: A Modest Proposal

- Dealing with the Debt Crisis
  - ECB can announce a Debt Conversion Program to service maturing debt corresponding to the percentage of the member-state's debt allowed by the Maastricht Treaty
  - This is funded by issuing ECB guaranteed bonds that are repaid by the member-state.
  - Upon issuing ECB bonds, a debit account is opened per participating member-states into which it is legally bound to make deposits to cover the coupon and principal

Verakoufis & Holland: A Modest Proposal

- Redressing low aggregate investment and internal imbalances
  - Europe is in need of shifting idle savings into profitable investments, especially in the deficit regions
  - European Investment Bank's must be allowed to contribute to projects funded by a net-issue of ECB bonds or European Investment Fund bonds

Verakoufis & Holland: A Modest Proposal

- Above three policies address the crisis without changing the treaty
- Furthermore, there is no German guarantee of others debts
- Addresses the crisis without Keynesian stimuli and Central Bank monetization.

Mosler Bonds

- “The cleanest and most efficient solution to our current debt crisis.” (Mosler & Pilkington, 2012)
- Would allow debtor nations to maintain sovereignty and return to markets without asking creditors to bail them out
- Tax-backed bonds would look like ordinary government bonds but with clause that allows them to be used in payment of domestic taxes in the event of defaut

Mario Draghi

- Pledged unlimited purchases of the government bonds of debtor countries
- But, they must reach an agreement with the EFSF and put themselves under the supervision of the Troika
  - EU, ECB and IMF

Kregel's Plan

- find the levy piece

“[I]t would be irresponsible for the government to reduce its outstanding indebtedness when households and firms are attempting to increase their savings” (Kregel, 2010).

The Fiscal Hawks

- The Fiscal Compact was signed March 2, 2012
- By all members of the EU except the Czech Republic and the UK
- Requires balanced budgets or surpluses
  - General budget deficit less than 3%
  - Structural deficit below 0.5% or 1%, depending on the country's debt-to-GDP ratio
- Imposes penalties and fines

Post Keynesians

- Warned that monetary policy would be not suffice in a severe downturn
- Emphasized the importance of fiscal policy as a stabilization tool
- Disagreed over how much fiscal space was needed

Dove Brains

De Long & Summers: In normal times… expansionary fiscal policy as stabilization policy has only costs and no stabilization-policy benefits (3/22/12)

Krugman: Yes, we have a long-run budget problem, and we should be taking steps to address that problem, mainly by reining in health care costs. But it's simply crazy to be laying off schoolteachers and canceling infrastructure projects at a time when investors are offering zero- or negative-interest financing. (7/26/12)

Baker: A serious discussion of the deficit will show that in the short-term the deficit is not a problem and that the longer-term deficit problem is really a problem of a broken U.S. health care system. (4/28/12)

Similar Advise to US Government

"End the exploding federal debt by controlling the growth of spending so federal spending does not exceed 20 percent of the economy."

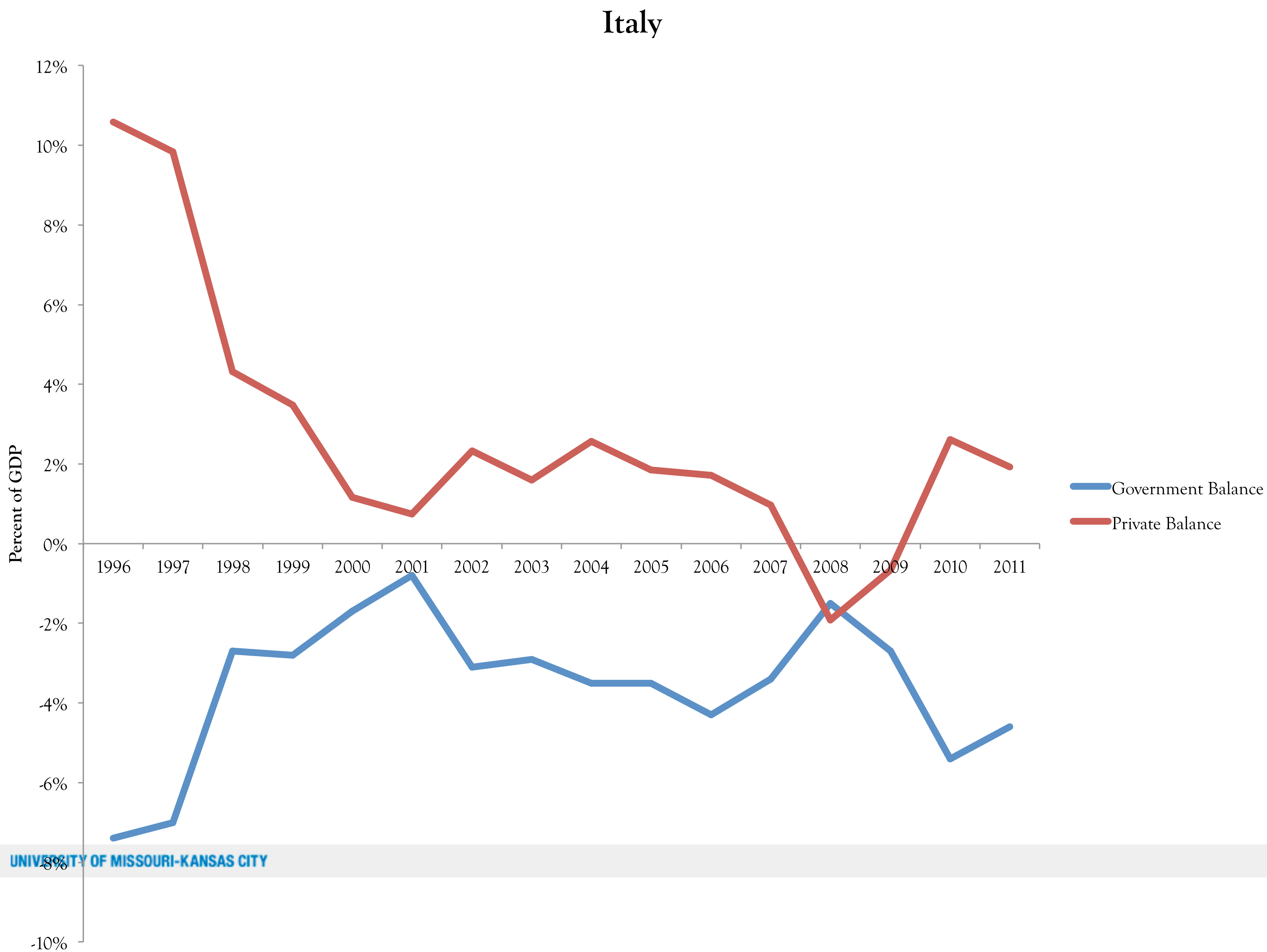
Gary Becker, Nobel laureate
James Buchanan, Nobel laureate
Robert Lucas, Nobel laureate
Robert Mundell, Nobel laureate
Edward Prescott, Nobel laureate
Myron Scholes, Nobel laureate

“[I]t would be irresponsible for the government to reduce its outstanding indebtedness when households and firms are attempting to increase their savings” (Kregel, 2010).

Godley Believed …

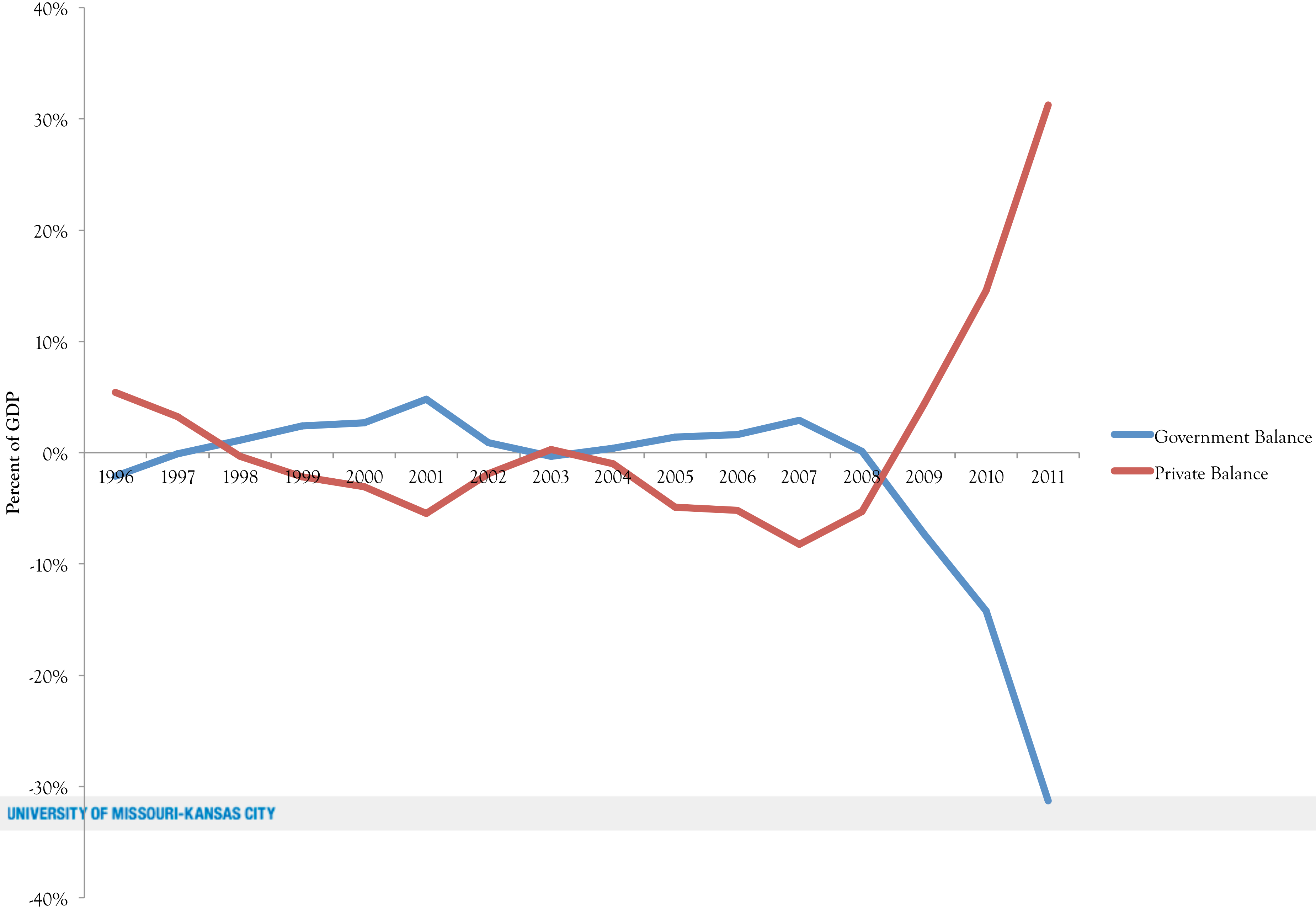
"I think that the central government of any sovereign state ought to be striving all the time to determine the optimum overall level of **public provision**, the correct overall **burden of taxation**, the correct **allocation of total expenditures** between competing requirements and the just **distribution of the tax burden**."

~Wynne Godley, 1992



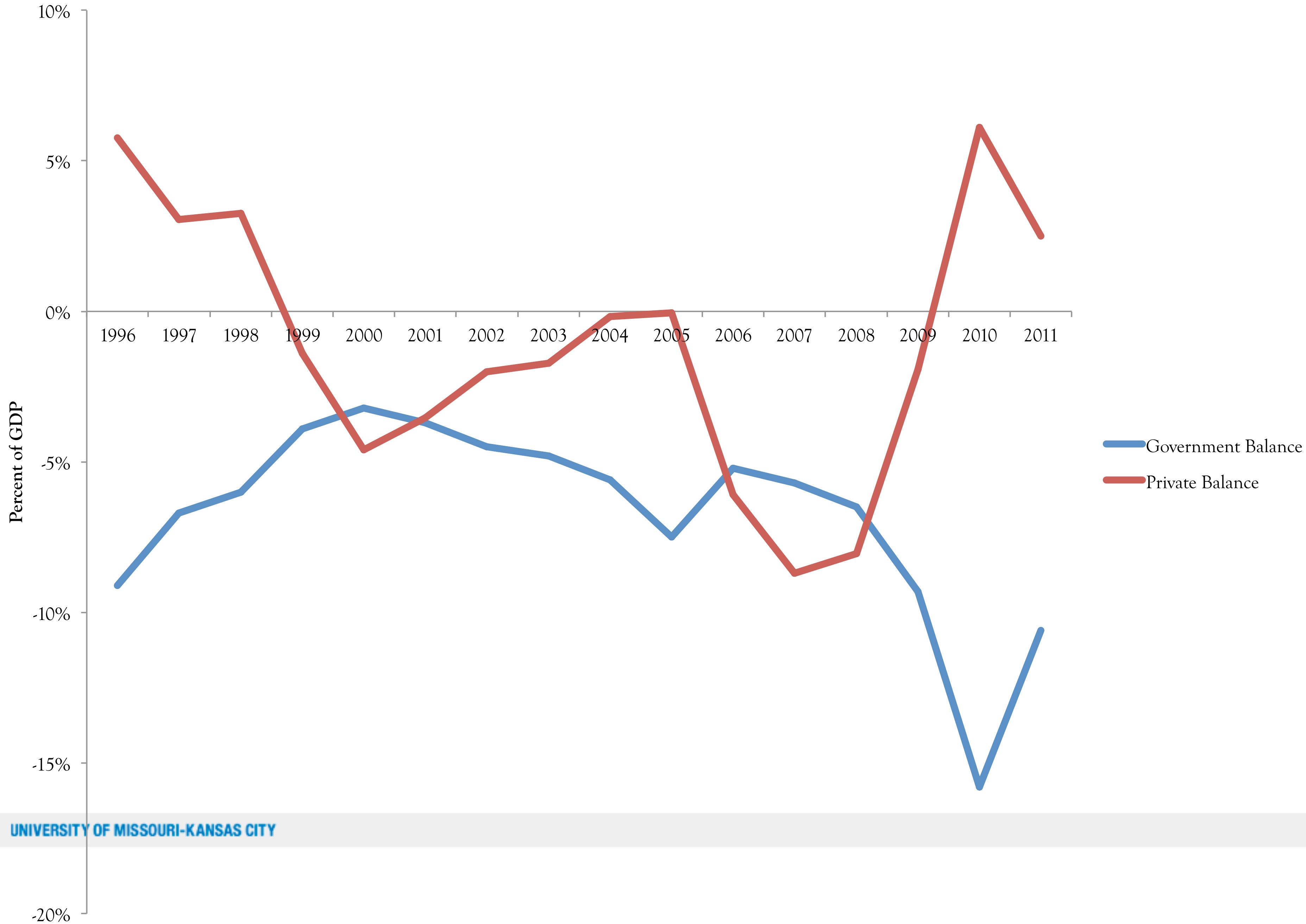
Italy
12%
10%
8%
6%
4%
2%
0%
-2%
-4%
-6%
-8%
-10%
Percent of GDP
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Government Balance
Private Balance

Ireland



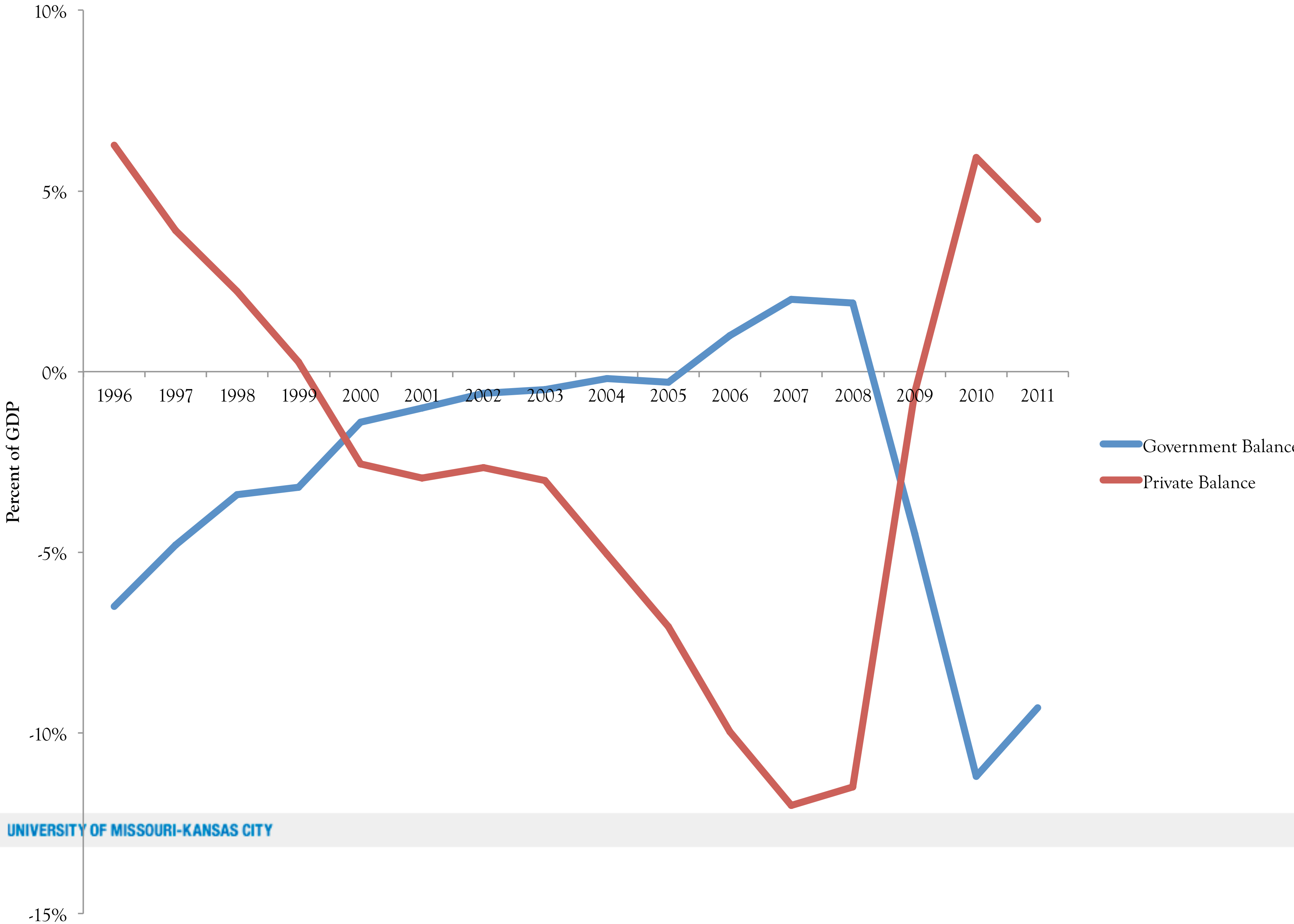
40%
30%
20%
10%
0%
-10%
-20%
-30%
-40%
Percent of GDP
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Government Balance
Private Balance

Greece

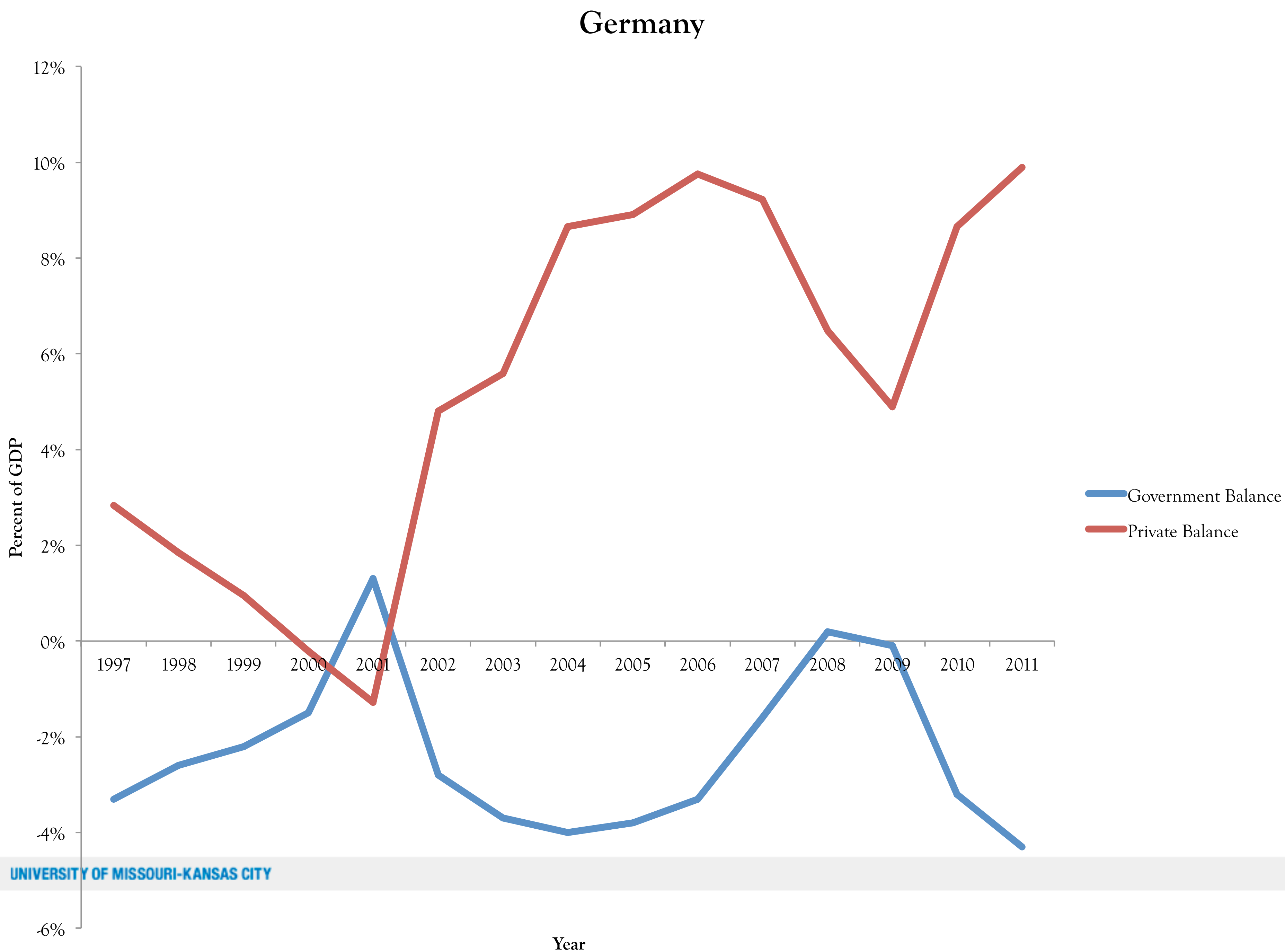


10%
5%
0%
-5%
-10%
-15%
-20%
Percent of GDP
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Government Balance
Private Balance

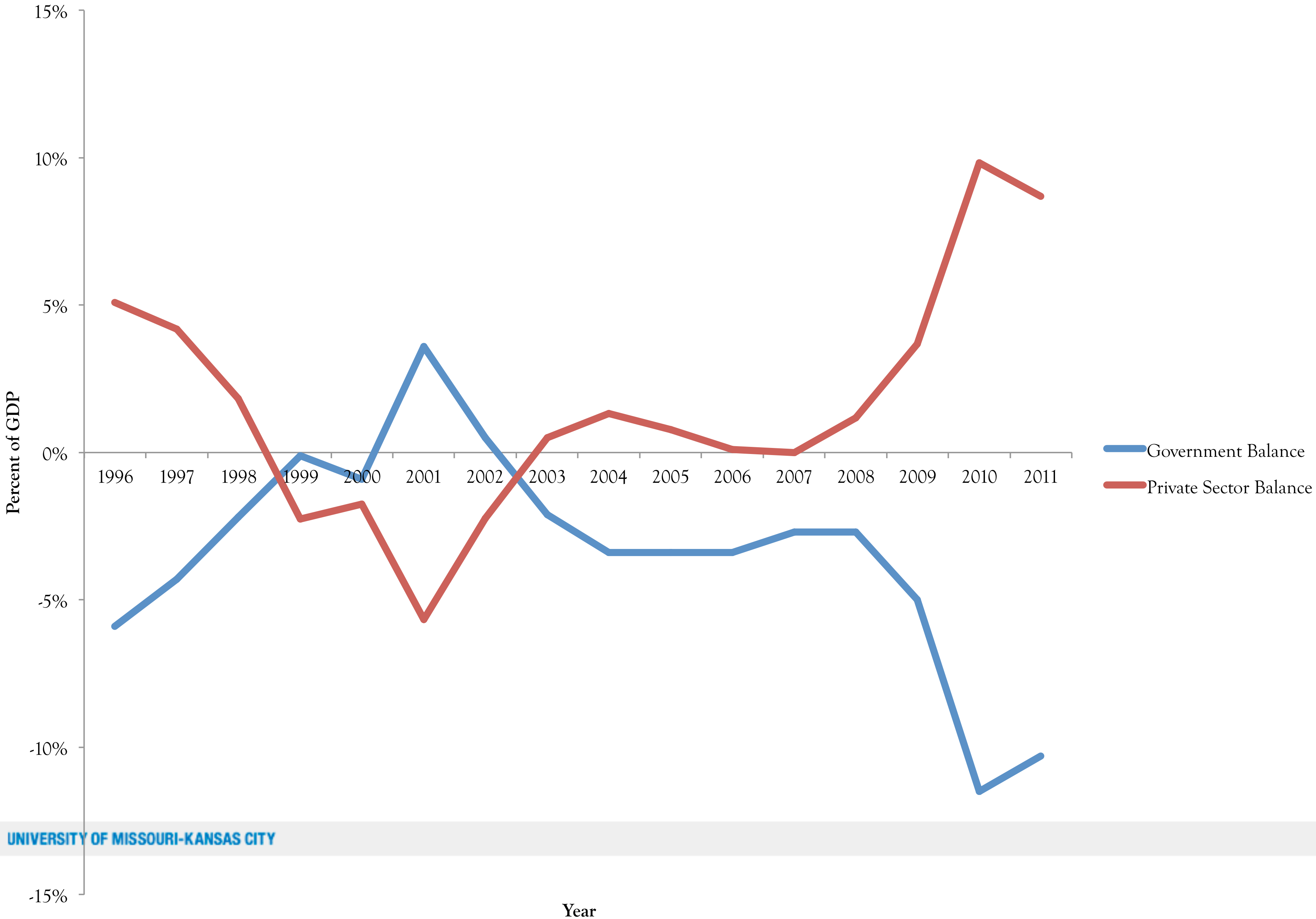
Spain

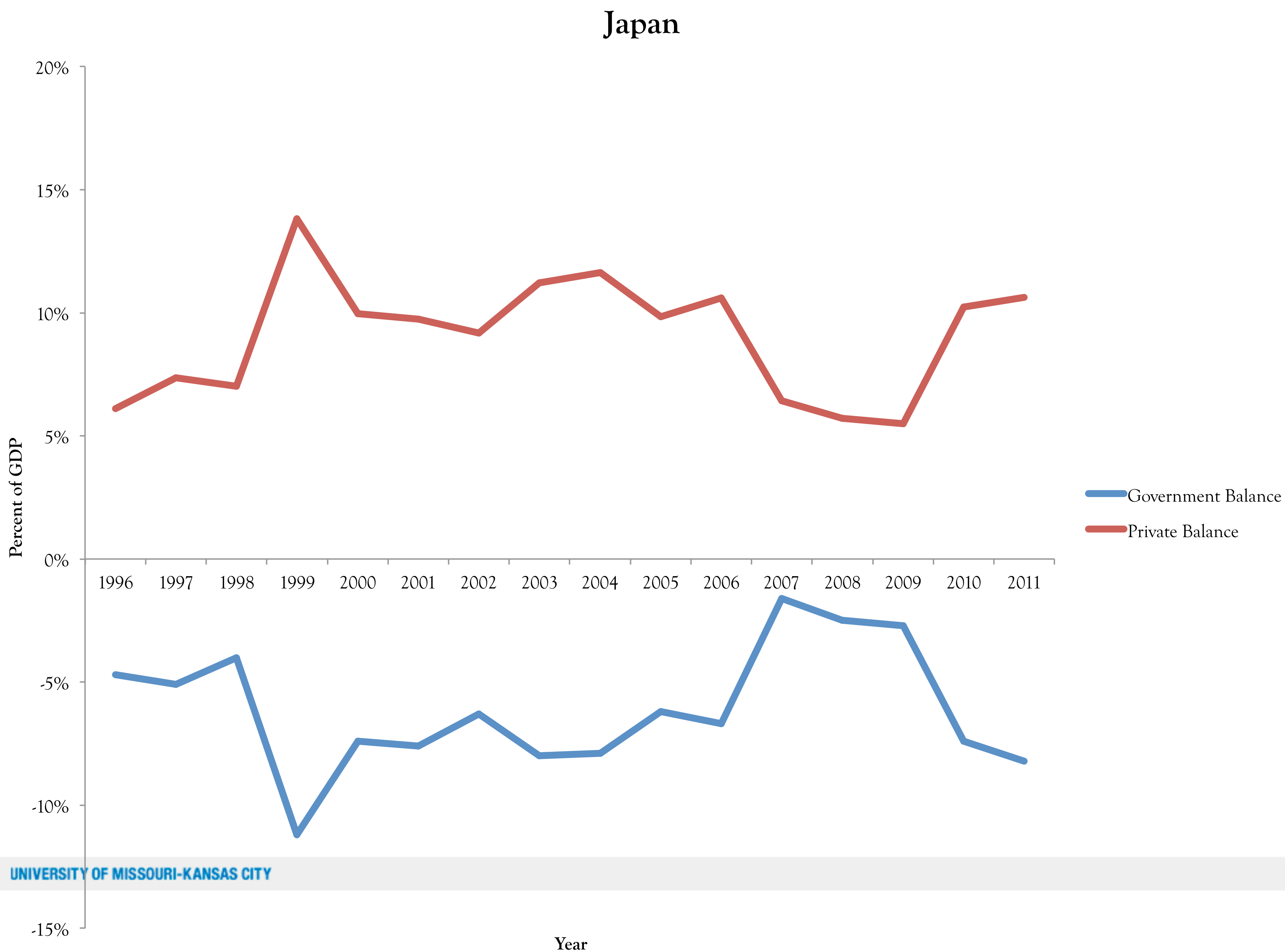


10%
5%
0%
-5%
-10%
-15%
Percent of GDP
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Government Balance
Private Balance


Germany
12%
10%
8%
6%
4%
2%
0%
-2%
-4%
-6%
Percent of GDP
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Year
Government Balance
Private Balance

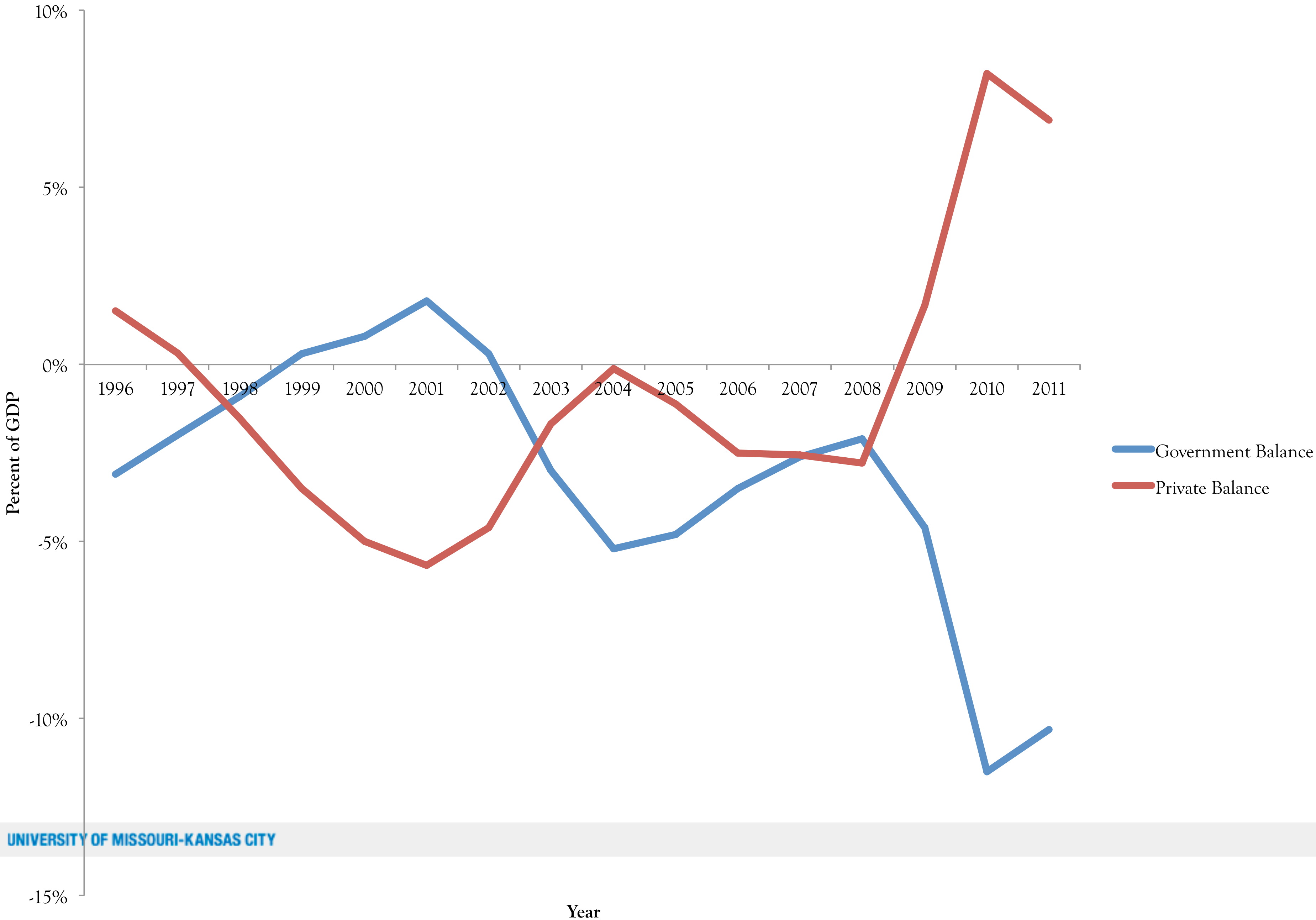
United Kingdom

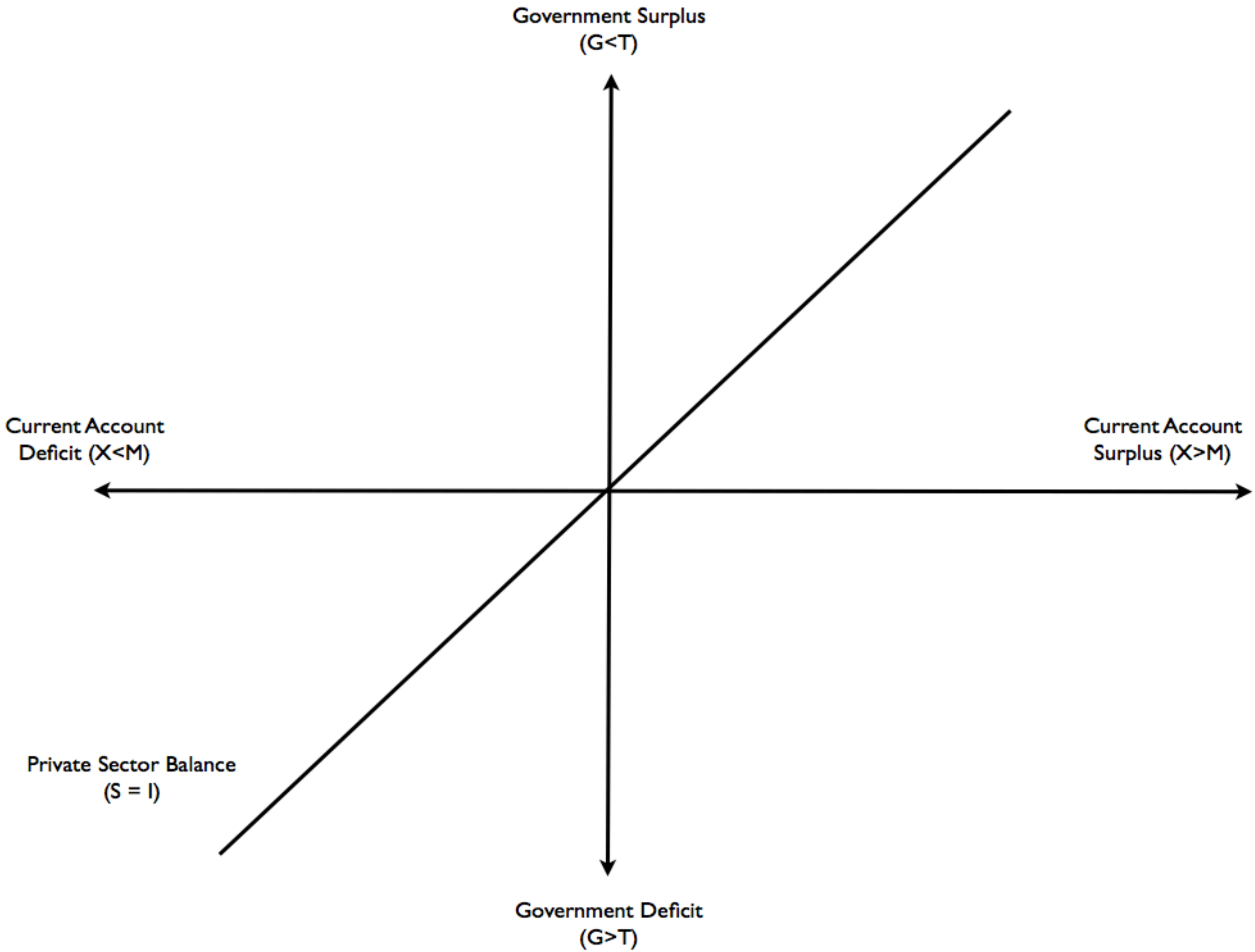




Japan
20%
15%
10%
5%
0%
-5%
-10%
-15%
Percent of GDP
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Year
Government Balance
Private Balance

United States




Government Surplus
(G<T)
Current Account
Deficit (X<M)
Current Account
Surplus (X>M)
Private Sector Balance
(S = I)
Government Deficit
(G>T)


Negameganumapobia
-$15 Trillion
17
"Calm down. The government deficit is our surplus."
~Stephanie Kelton, Ph.D


Negameganumapobia
-$ 17 Trillion