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THE FISCAL FACTS: PUBLIC AND PRIVATE DEBTS AND THE FUTURE OF THE AMERICAN ECONOMY

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Today's federal budget deficits are a preoccupation of many American citizens and more than a few political leaders. Is the American government going bankrupt? Does our fiscal condition warrant radical surgery, as some now prescribe? Or, are we in such deep trouble that there is no plausible route of escape?

It might surprise you that my answers to all of these questions are in the negative. My economist father, once asked to comment on some disaster in the inflationary 1970s, advised that "one should never blame the Almighty so long as Richard Nixon is available." I confess that I feel much the same way about George W. Bush. Nevertheless, on this issue, circumstance and conviction force me to take a nonpolitical stance.

The American government is not going bankrupt and will not go bankrupt. Legally, of course, it cannot. Bankruptcy is a specific legal condition, applied for by a debtor and granted by a court, in relief of unpayable debts. Individuals, companies, and municipalities can go bankrupt, but sovereign states cannot. The application of the word "bankrupt" to the government of the United States is therefore at best legally inappropriate. At worst, it is gratuitous and inflammatory.

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The term "bankruptcy" is sometimes used to describe the underlying economic condition that leads to a legal declaration. In this sense, too, the U.S. government cannot go bankrupt. The reason is that the debts of the U.S. government are valued in dollars. Payment of those debts is therefore nothing more or less than the exchange of U.S. government bonds for Federal Reserve notes or their electronic equivalent. In a modern credit economy, there is no limit on the issue of such notes, no fixed supply of money. Therefore, a failure to redeem public debts when due is unimaginable. While Argentina could be denied access to U.S. dollars that it needed in order to pay its dollar-denominated debts, the United States can never be placed in this position.

The term bankruptcy is also often used metaphorically to describe something more subtle than either legal bankruptcy or the practical inability to pay debts. Rather, it is used to describe a situation in which U.S. financial assets, both public and private, fall sharply in value simply because the rest of the world chooses to no longer hold those assets and cannot be induced to hold them. Let us examine this possibility.

The United States has been running a current account deficit—an excess of imports and other current payments over exports and other current earnings—almost continuously since the early 1970s. That is to say, in almost every year, the United States has borrowed from foreign residents to finance its consumption, investment, and public spending. Presently that borrowing amounts to about 5 percent of national income, and in recent years it has been rising.

Many people, including economists, are alarmed by this. They are not necessarily wrong. This situation cannot last forever. When it unravels, the value of the dollar could drop dramatically. Such a drop would reduce U.S. living standards on average, by making some imports much more expensive. It would also redistribute income inside and outside the United States in complicated ways that would hurt some interests and benefit others.

But, the sun will eventually explode, and the universe may eventually collapse under the weight of cold, dark matter. The question for us is, how soon? I believe that the answer is largely out of economists' hands. There is very little that we can do to make a collapse less likely or more remote in time. In fact, the usual prescription, to cure the current account deficit by cutting the budget deficit, almost certainly will not have this effect.

The dollar's status as the world's principal reserve currency may endure—not forever, but for some time—for two reasons. First, it is not in the interest of key players outside the United States to permit it to collapse in the near term. Second, there is no good and ready alternative to the dollar; that of the euro remains for now on the horizon.

Many U.S. bonds are bought every year by the central banks of Japan and of China, as well as in lesser degree by other countries, despite the fact that U.S. interest rates are remarkably low, that these countries do not need additional foreign reserves to protect their currencies against speculative attack, and that they do not need additional earnings in order to purchase the imports they need on the world market.

They do this because it serves their purposes. Japan is a rich and powerful industrial nation, with a strong export orientation and lagging domestic consumption. For Japan to increase its imports would not be easy, while to reduce its exports would court political crisis. Japan's surplus is an artifact of this structural imbalance. Its choice to hold its accumulated surplus in dollars reflects in part the comparative scarcity and risk of alternative assets, and in part the historic United States–Japan security relationship. To change now would be disruptive and costly, not only to the United States, but even more so to Japan. I'm not claiming that the foreign trade deficit will never be reversed, only that there are good reasons why that development is not necessarily imminent.

China is a vast developing nation managing the largest wave of urbanization in human history, and export industries are a prime mover of Chinese growth and the anchor of its economic security. China's accumulated surplus is in dollars because its primary market is the United States. Again, to change would be costly, difficult, and risky. It could happen, especially if the political relationship between the United States and China turns sour, but it needn't necessarily happen. More important, neither China nor Japan is going to panic just because they fear a mild decline in the dollar's value.

But suppose they did? The major alternative is the euro, and the euro is scarce. There are, in fact, no proper European bonds on the market, only euro-denominated bonds of individual countries, such as Italy. A major effort to buy those up would, of course, drive the euro up and drive the dollar down. This in turn would hurt the Europeans, with the likely result that they would buy dollar assets—the bonds that China, Japan, and other nations would be seeking to sell. The net result would be a redistribution of dollar asset holdings, no doubt with some decline in the dollar's value, but that alone would not put an end to the dollar system.

Finally, if one could wave a wand and erase the U.S. current account deficit, either by raising exports or cutting imports by 5 percent of GDP, would that erase the dangers, however great or small, that hang over the international monetary system? It would not. Every penny of the accumulated bonds would still be out there. All of the potential disruptions to the system would still be present. Looking forward, the reasons to preserve the dollar basis of the system would tend to decline over time if the United States were no longer buying the imports that generate the dollar reserves, particularly if some other region, especially Europe, were to start running the current account deficits the United States abjured, and thus become the preferred supplier of international reserves.

The metaphorical "bankruptcy of the United States," under which foreign asset-holders rush to dump U.S. assets and provoke a run on the dollar, is a possible but not a likely or a looming event. Moreover, the risks are not closely related to the present size of the U.S. current account. They stem far more from circumstances that might disrupt the world trading system or change the motivation of its key players, perhaps especially the Chinese. The recklessness of U.S. foreign policy is here a greater danger than the fecklessness of U.S. trading partners. A war over Taiwan is the sort of catastrophe one might worry about. An American attack on Iran, disrupting Chinese oil supplies, is perhaps another.

I dwell on the current account first, because there is a direct line between that and the budget deficit. So long as the private sector—households and businesses—remains in financial balance, then the budget deficit of the government and the current account deficit of the country are, and must necessarily be, equal. Under the assumption stated, a 5 percent deficit in the current account implies a 5 percent deficit in the federal budget.[1]

Let me put this another way. Under the assumption stated, tax policy and expenditure decisions—the meat and potatoes of the budget process—do not affect the budget deficit. (They affect the *projected* deficit, but not the *realized* deficit.) The government can cut spending, or raise tax rates, but so long as the current account remains at 5 percent of GDP and the financial balance of the private sector is undisturbed, the budget deficit will remain at 5 percent. If one could erase the current account deficit or persuade the private sector to go sharply out of financial balance, the budget deficit would necessarily disappear.

How does this work? The trick is in the assumption. Cutting spending and raising taxes reduces the incomes of the private sector. If the private sector cuts its own spending to match the reduction in its incomes, then tax revenues will fall (and welfare spending will rise) by just enough to keep the deficit where it was before.

On the other hand, if the private sector spends ahead of its income, the budget deficit can be made to disappear without changes in tax or spending policy. This is essentially what happened during the boom of the late 1990s. The difficulty is that booms of this nature cannot be sustained. The U.S. economy had one from 1926 to 1929 and another from 1996 to 1999. No other booms in the past century fit the bill. The private sector may be willing, once or twice in a lifetime, to spend far ahead of its income, but it will not be willing to do this for more than a few years at a stretch. When it quits, the budget deficit will revert to equal the current account. That is what happened in the first four years of the present decade. In the last year or so, somewhat stronger economic growth reflected a willingness of private businesses to begin to raise funds in the capital markets to finance new investment. The necessary consequence was a modest decline in the budget deficit, which duly occurred. It caught the budget forecasters by surprise. The same forecasters for similar reasons failed to predict the sharp swing of the budget into surplus in the 1990s.

At present, the American private sector has returned to a net deficit position of about 2 percent of GDP, reflecting the recovery of private business investment from the stagnant period at the start of this decade. Thus, the actual 6 percent current account deficit translates into a 4 percent budget deficit. That brings me to my second question: does the U.S. fiscal picture require radical surgery, raising current taxes and cutting current spending? I answer that it does not. That does not mean that I do not favor big policy changes. I do. My beliefs are fairly quaint, at least in the current political setting. I believe in a more progressive tax system, in a more efficient military focused on realistic security objectives, and in universal health insurance that is not a burden on families or employers. Moving all health insurance to a single-payer system would, as a matter of accounting, raise both the revenues and the disbursements of the government, hence the share of government in GDP. I believe that these steps, and others I could mention, would be good for the economy. The point, however, is that these changes, if enacted, would not affect the budget deficit or the current account.

Progressive tax measures that increase projected revenues in the years up to and following 2010 might be wise policy, but

they are immaterial to present conditions. The markets are well aware that decisions taken between now and then will affect those numbers, and there is neither reason nor evidence to believe that the technical projections for a distant future should have a large impact on present times. The purpose of showing a smaller future deficit is almost completely political: it will embolden (one hopes) otherwise recalcitrant legislators to act on urgent problems.

Moreover, the fiscal condition of the government does not require a radical assault on or indeed any reduction of Social Security benefits. Taken as a system of pension benefits and dedicated tax revenues, Social Security is far from being in crisis; it is actually in the best financial condition in its history. The "solvency of the system" does not require radical cuts in health care or large tax increases, either now or in the future; still less does it call for a transition to privatized accounts.

Some claim that large deficits raise interest rates and hence discourage investment. My rebuttal is based on two facts. First, interest rates were higher when the budget was in surplus than they are today when deficits stretch to the horizon. Second, investment, as a share of GDP, is higher today than its long-term historical average and not far below the peak values of the boom years of 1999–2000. There is no convincing evidence that we pay any penalty, either in higher interest rates or in lost investment, for today's large deficits.

The United States remains, on the whole, a wealthy country. There is no compelling *fiscal* reason why it cannot afford to address its ongoing problems. The reconstruction of New Orleans and the creation of a viable plan for the rehabilitation of the Gulf Coast are urgent priorities. The federal government has an appropriate role to play, and it can afford to do so without reneging on its other social commitments. Would it be wise to program rising tax revenues in future years to help offset some of the projected costs, for whatever effect projections of future spending and taxes may have on financial markets? Yes, on prudential grounds it would be wise to do that. Is it necessary to raise taxes now, or to raise them for the future before constructive action to meet urgent national priorities is taken? No, it is not.

Private bankruptcies are of greater concern. We are living, obviously, in the twilight of the great American airline. We are approaching, with each passing day, the twilight of the great American automotive corporation. What other major corporate bankruptcies lie in wait? How many more pension plans will fail? Time will tell, but it is sure that a bankrupt corporation is a poor candidate to exercise world technological leadership or to provide the employment and the exports for the future.

The prospects facing the American household are equally ominous, perhaps more so. American households have in recent years continued to add to their debts. In relation to incomes, those debts are at record levels. Debt service remains manageable only because incomes have been growing, however slowly, while interest rates have remained low, but one or the other of these conditions is not likely to endure.

In January, Professor Ben Bernanke assumed the chairmanship of the Federal Reserve Board. He may find that former Chairman Alan Greenspan has left him with an uncomfortable choice. He can continue, as he has promised, the policy of raising short-term interest rates. If he does that, and long-term interest rates do not rise, the economy is likely to fall into recession within a year. The effect of that on private incomes could be disastrous for the repayment of debts.

Alternatively, long-term interest rates may begin to rise, either because government bond rates adjust to the prospect of higher short-term rates, or—more likely—because banks seek out increasingly speculative projects and clients, accepting higher risk as the price of maintaining the spread between their revenue and their cost of funds. Either way, effective mortgage rates will rise and house prices are likely to fall. Households will be caught between the rising price of their debt service and the falling value of their collateral. They will adjust primarily by trimming their spending, especially on new homes and durable goods.

Complicating the picture further is the new bankruptcy law. This gift to the credit card companies prompted many thousands of Americans to file for bankruptcy before its passage, including many who would otherwise have chosen to soldier on. Under the law, escape from debt has become much more difficult, and for those whose finances fail in the future, the new law in effect imposes a high tax on future work effort. It will have the effect of pushing many Americans out of the workforce and many others into the cash economy. The credit card companies should have been careful about what they wished for.

A further complicating factor is the large population of hurricane evacuees, many of whom are financially shattered but were unable to file for relief in time because their records were under water or, indeed, because the courts in southern

Louisiana were closed. Add to this the bankruptcy of municipal government in the affected region, beginning with the City of New Orleans, and the financial burden on local utilities.

Looming over all of this is the remote prospect of major tax reform, which crossed the public radar screen recently. The Bush commission has recommended, among other things, that mortgage interest deductibility be curtailed. Perhaps the household sector is overinvested in housing, but the effect of this measure would be to cut the bottom out of the housing market, leaving vast numbers of households financially under water. This is an unlikely scenario, but if it happens, the consequences could be grave. There is an old banker's adage, which Rudiger Dornbusch once quoted somewhere: it's not speed that kills, it's the sudden stop.

There is a great tendency in public discussion of fiscal matters to focus exclusively on the public sector. This focus is misplaced. The public sector suffers from many derelictions and deficiencies, but the prospect of financial bankruptcy need not detain us. The real danger to the economy is not in there. It is out here, among us. It would be a failure to use the resources we have in common to restore health to private balance sheets before it is too late. It would be a failure to address our common problems before private parties are forced to try to save themselves individually. That, like the proverbial run on the bank or shouting fire in the crowded theater, is truly the recipe for disaster.

Note

1. To be a bit more precise, the present financial balance of the private sector is about minus 2 percent of GDP, the current account balance is the sum of the private and public deficits, and the recent decline in deficits was due to the willingness of the private sector to take an increasingly negative position. See Godley et al. (2005) for a pessimistic view.

Reference

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