Fiscal Constraints & the Economy: 4 Politically Incorrect Questions

Rob Parenteau, CFA
MacroStrategy Edge
Levy Economics Institute
April 14, 2011
Fiscal Constraints & the Economy

- What is the real government budget constraint?
- How do fiscal constraints restrict the range of possible outcomes for other sector financial balances?
- Does financialization lead to lower corporate reinvestment rates (and hence larger fiscal deficits)?
- Why can “expansionary fiscal consolidations” prove to be so elusive?
The Government Budget Constraint

\[ G = T + d(D) + d(M) \]

- \( G \): Government Expenditures
- \( T \): Tax Revenues
- \( D \): Government Debt Outstanding
- \( M \): Money Stock

Solvency defined:
\[ \text{PV of future (T-G)} = \text{or} > \text{initial D} \]
Tax payments and bond purchases require money
Households and firms cannot create money
Where does the money come from then?
Money Creation and Fiscal Budgets

- Banks create money when they credit a deposit account as they make loans, buy securities.

- But this is not a net financial asset of the private sector.

- Central bank debits Treasury account, credits a bank account when it buys goods, services from private sector.

- This is a liquid net financial asset of the private sector that can be used to buy government bonds, pay taxes.

- Governments with a sovereign currency have to first create the money they collect as taxes, bond revenues.
The Government Budget Constraint

- Tax obligations force the private sector to sell goods, services, assets to the government for money.

- A government with a sovereign currency can never “run out of money”: it creates the money it collects.

- Government constraint is not financial (unless self-imposed as with debt ceilings, etc.) but rather real.

- Fiscal balance needs to be set with regard to real capacity constraints in labor, P&E, resources.

- Rating agencies should be assessing inflation risk, not default risk, for sovereign currency nations.
Fiscal Constraints on Other Sector Financial Balances

Total Saving = Total Investment
(or Total Income=Total Expenditures)

3 Sector Financial Balances (FB) in 3 Possible States (+, =, -):

- Government FB = T - G
- Foreign FB = M - X, (or inverse of Current Account Balance)
- Domestic Private Sector FB = (Sh + Sb) - (Ir + Inr)

DPSFB + GFB + FFB = 0 (as financial balances must net to zero)

DPSFB + GFB - CUB = 0

Change in one sector financial balance implies changes to other two
The Financial Balance Approach

- Changing the FB for one sector will have implications for the remaining sectors (range of possible outcomes)

- For DPS to net save, need a) fiscal deficit, or b) trade surplus, or more generally, CUB > GFB
3 Sector Financial Balances Map

Domestic Private Sector Financial Balance = Current Account Balance - Fiscal Balance

- Domestic Private Sector Financial Balance = 0%
- DPS Deficit
- DPS Surplus
- Fiscal Surplus
- Fiscal Deficit
- Current Account Deficit
- Current Account Surplus
Balanced Budget Constraint

- Fiscal Surplus
- DPS Deficit
- DPS Surplus
- Current Account Deficit
- Domestic Private Sector Financial Balance = 0%
The EMU Triangle

Current Account Deficit

Domestic Private Sector Financial Balance = 0

Fiscal Deficit

Fiscal Surplus

Current Account Surplus

Very little room to achieve a Domestic Private Sector Surplus

Fiscal Deficit = -3% of GDP

Fiscal Deficit
Fiscal Deficit > Current Account Deficit = Large Private Sector Financial Surplus

Current Account Balance as a Share of GDP

Government Financial Balance as a Share of GDP

Source: Haver Analytics
US Households in a Net Saving Mode

Household Financial Balance as a Share of GDP

Source: Haver Analytics
Nonfarm Nonfinancial Business Financial Balance as a Share of GDP

4-qtr Moving Average

Source: Haver Analytics
Profit Margins Soar, Investment Share Low

Pretax Corporate Profits as a Share of GDP

Capital Equipment and Software as a Share of GDP

Source: Haver Analytics
US Capital Stock on a Diet: Financial Incentive Constraint?

Net Stock: Private Structures: Quantity Index
% Change - Year to Year 2005=100

Net Stock: Private Equipment & Software: Quantity Index
% Change - Year to Year 2005=100

Sources: Bureau of Economic Analysis / Haver Analytics
US Business Financial Balance and the Unemployment Rate

Unemployment Rate
12-month Moving Average SA, %

Domestic Business Financial Balance
4-qtr Moving Average

Source: Haver Analytics
Tobin’s Q: Signal to Reinvest, not M&A

Nonfarm Nonfinancial Corporate Business: Market Value of Equities/Net Worth

%

Source: Federal Reserve Board / Haver Analytics
Corporate Reinvestment Rates

- Incentive structures for managers and investors have shifted over 30 years toward short term financial gains.

- With exception of the New Economy Bubble, reinvestment of profits in US capital stock has been low.

- US job growth (and tax revenue growth) are dampened if firms fail to reinvest profits in tangible capital stock.

- Changing incentive structures (and public/private investment) may be required to revive secular growth.
Expansionary Fiscal Consolidations

- Tax hikes and government expenditure cuts drain domestic private sector cash flow

- Growth then requires DPS to spend more out of its income flows (higher corporate reinvestment, for eg.)

- Or requires trade balance to improve

- Or combination of both in sufficient size

- No automatic price adjustment (dollar, interest rate) insures sufficient offsetting DPS and/or CUB shift
Fiscal Consolidation...or rediscovering the Paradox of Public Thrift?

U.K.: Public Sector Budget Surplus/Deficit as a % of SA GDP (SA, %)
Ireland: Central Government Budget Surplus/Deficit as a % of SA GDP (SA, %)
Spain: Central Government Budget Surplus/Deficit as a % of SA/WDA GDP (SA, %)

Sources: ONS, ICSO, SPBDEH /Haver
Expansionary...or Double Dip?

UK Real GDP (YoY % Change)
Ireland Real GDP
Spain Real GDP

Sources: ONS, ICSO, SPENE /Haver
EU Trade Balances Not Helping

Euro Area16: Trade Balance: Total
SA/WDA, Mil.EUR

Source: Statistical Office of the European Communities /Haver Analytics
The true government budget constraint for nations with sovereign currencies is not financial, but one of real productive capacity.

Constraining fiscal deficits will reduce the capacity for private sector to spend less than it earns (net save, reduce private debt).

The business sector will be hesitant to reduce its net saving without incentive structures less driven by short term financial returns.

Expansionary fiscal consolidations require current account balances to improve or the domestic private sector to reduce its net saving.