DOES EXCESSIVE SOVEREIGN DEBT REALLY HURT GROWTH?

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Deficit Hysteria

"Although fiscal consolidation may imply costs in terms of lower economic growth in the short run, the longer-run beneficial effects of fiscal consolidation are undisputed." *(ECB, Monthly Bulletin, June, 2010)*

"Fiscal adjustment is key to high private investment and long-term growth. It may also be key, at least in some countries, to avoiding disorderly financial market conditions, which would have a more immediate impact on growth, through effects on confidence and lending." *(Blanchard and Cottarelli, Ten Commandments for Fiscal Adjustment in Advanced Economies, IMFDirect, June 24, 2010)*

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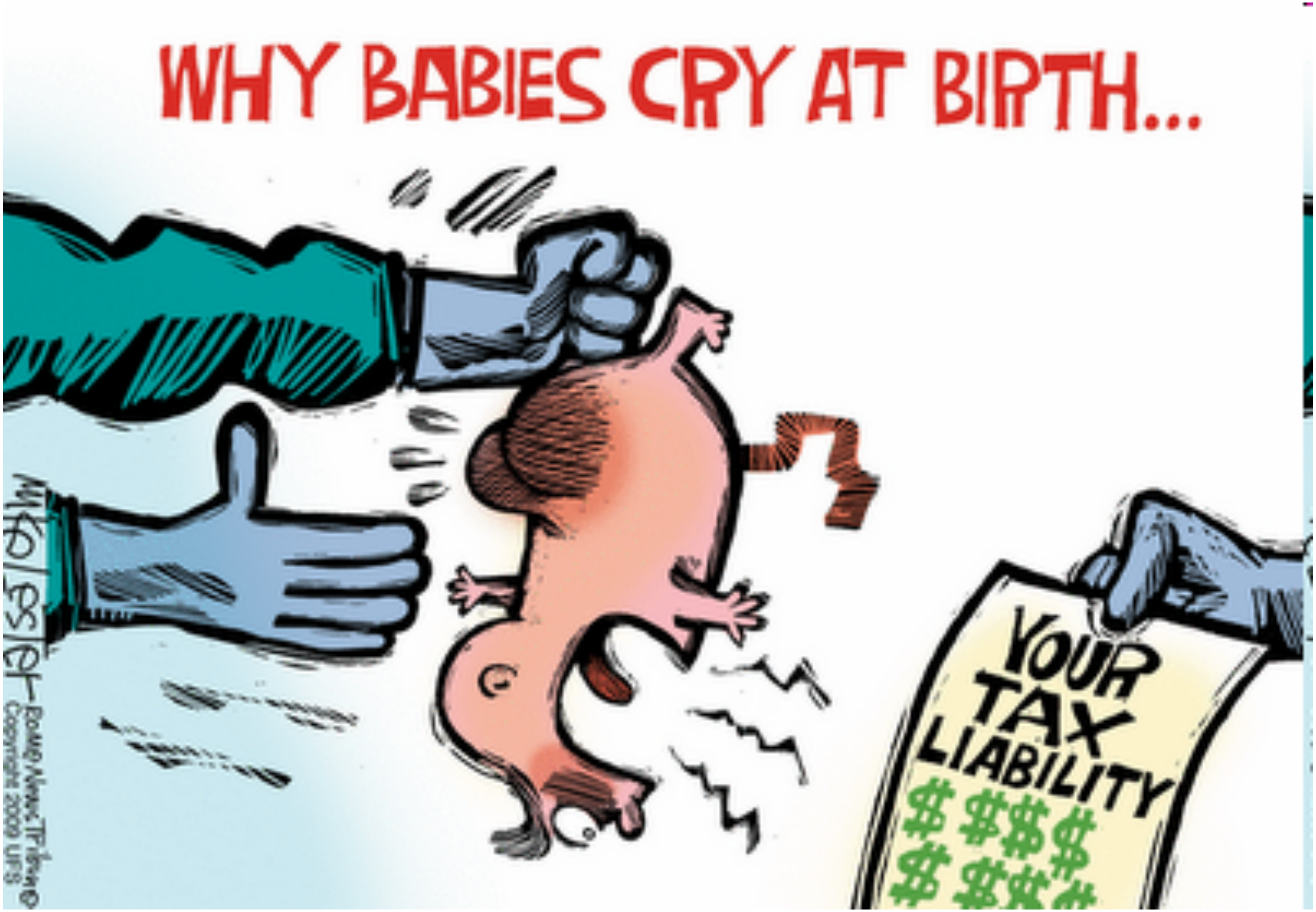
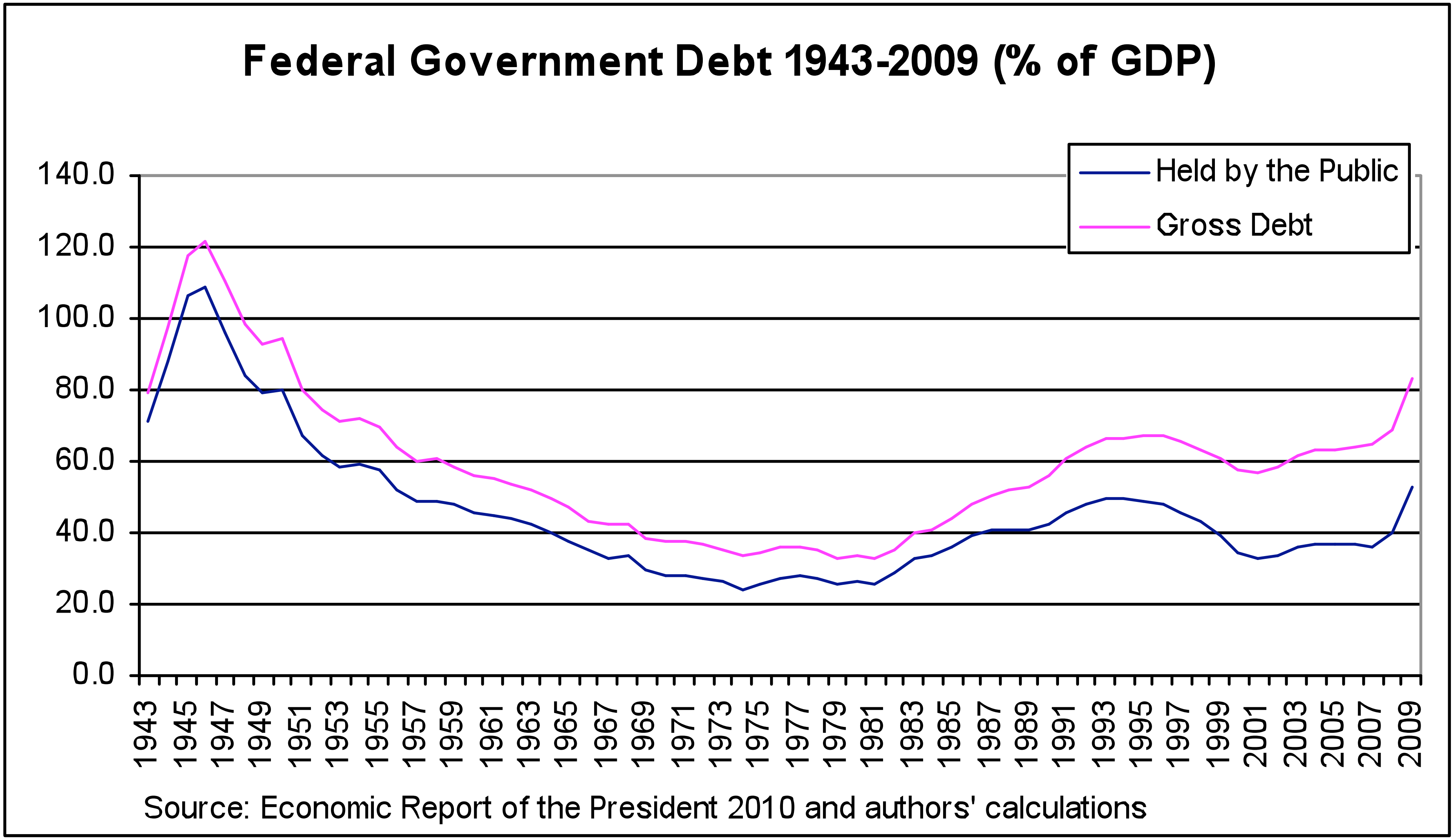

WHY BABIES CRY AT BIRTH...
YOUR TAX LIABILITY



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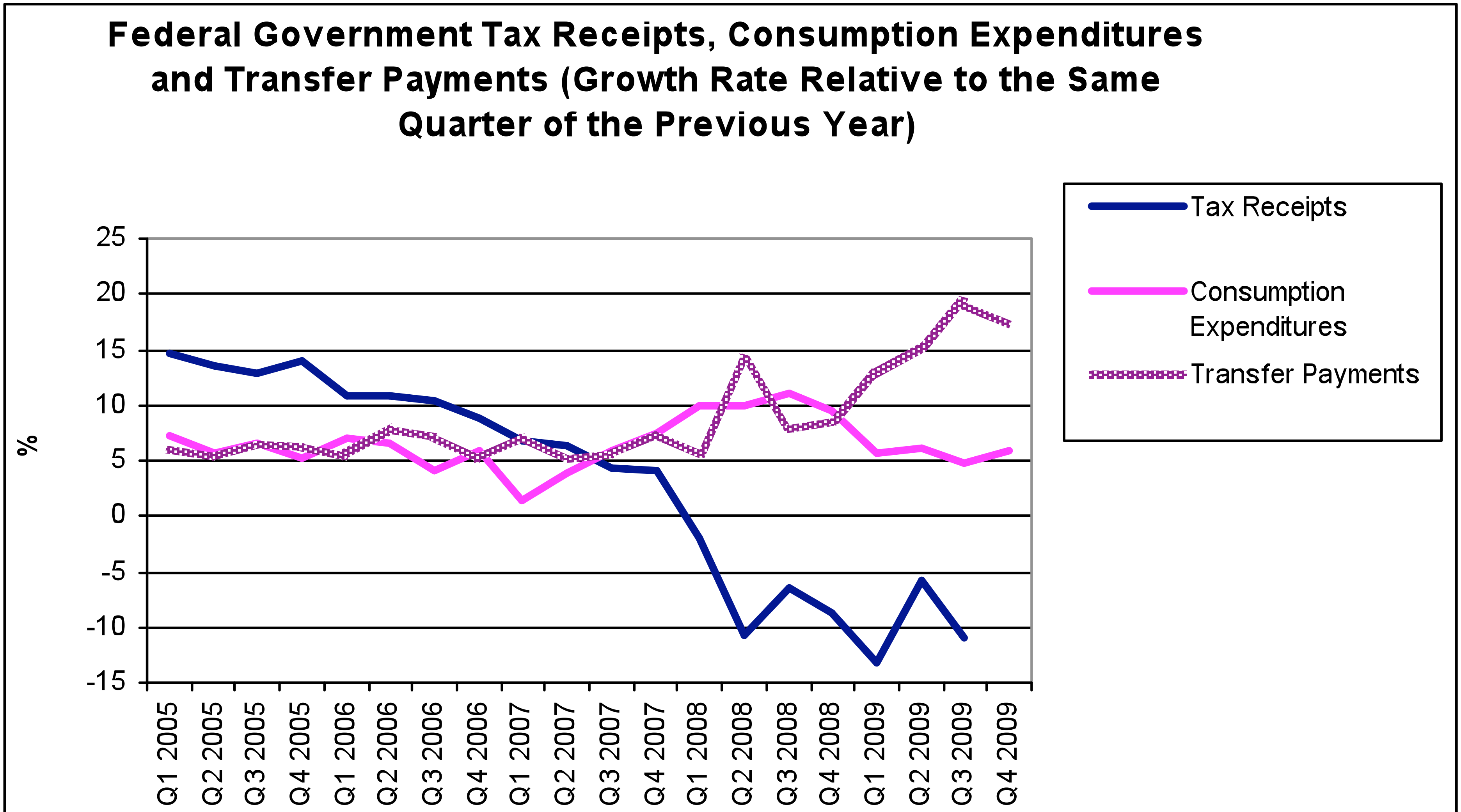

Source: Bureau of Economic Analysis and Authors' Calculations; Tax Receipts Data Unavailable for 2009 Q4

Two main problems with government deficits and debt

- Sustainability issue
  - Relations among interest rates and economic growth
  - Excessive Deficit-to-GDP and Debt-to-GDP ratios
  - Inflation tax
- Growth issue
  - Crowding out effect
  - Ricardian equivalences
  - Inefficient use of resources by governments

This Time is Different – Reinhart and Rogoff

- Used by a number of commentators to argue that U.S. deficit and debt are unsustainable and to draw parallels with Greece
- WSJ called it "one of the most important economics books of 2009"
- Empirical evidence of the relations among debt, financial crises, inflation, currency crashes and sovereign defaults
  - Claim to cover eight centuries and sixty-six countries
  - Identify 250 sovereign external defaults and 70 defaults on domestic public debt
  - "Serial default" is the norm through history and around the globe -- with almost no "default virgins"

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Growth in Time of Debt

- Developed and Developing Countries:
  - Beyond a debt/GDP ratio of 90% growth suffers with median long term growth falling by 1% point and average growth falling by more.

- Developing Countries:
  - Growth falls by 2% point when the ratio of externally held government debt to GDP hits 60%.
  - Growth becomes negative at a ratio beyond 90%.

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Misgivings

- Exchange rates, monetary regimes and institutions vary significantly over the covered period
  - e.g. last time the U.S. defaulted was in 1933 when it was on a gold standard and had a very small government (6% of GDP)

- Classify debt as domestic and foreign based on the ownership of the security not the currency of denomination
  - Although there is some recognition of the importance of the currency of denomination, the data is not categorized on this basis

Misgivings

- Use average and median Debt/GDP values across different countries and time periods to draw conclusions about debt and growth in general
- Average growth rates higher at mid-range levels of debt (60-90% of GDP) than at low levels of debt (30-60% of GDP)
- Growth rates didn't deteriorate for some of the countries in their sample at levels of debt over 90% - no explanation
- Not enough observations
  - only 2.3% of observations for the U.S. were for debt/GDP above 90% (3 of these were for 1945, 1946 and 1947)

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Misgivings

- Explanation in terms of the Ricardian Equivalences
  - Correlation doesn’t mean causation
  - US debt held by the public increased from 36% of GDP in 2006 to about 52% of GDP by 2009 largely due to automatic stabilizers

- Add together public and private external debts
  - If it’s denominated in domestic currency the only thing that matters is private debt
  - If it’s denominated in foreign currency then external debt can be dangerous even at low levels of debt since it depends on the ability to earn foreign currency

Debt is Debt…or Is It?

- Important distinction is the currency of denomination not ownership
  - Why do countries convert foreign currency liabilities into domestic currency during crisis?
  - Case of Japan
  - Divide countries *not* into developed and developing but sovereign and non-sovereign

- When a country pegs its currency to another currency/ metal it is constrained in its ability to spend
  - Extreme case – Eurozone - loss of currency sovereignty

- Reinhart-Rogoff results *may* be applicable to foreign-currency denominated debt or to a country like Greece or Germany but not to the U.S. or any other sovereign currency issuing country

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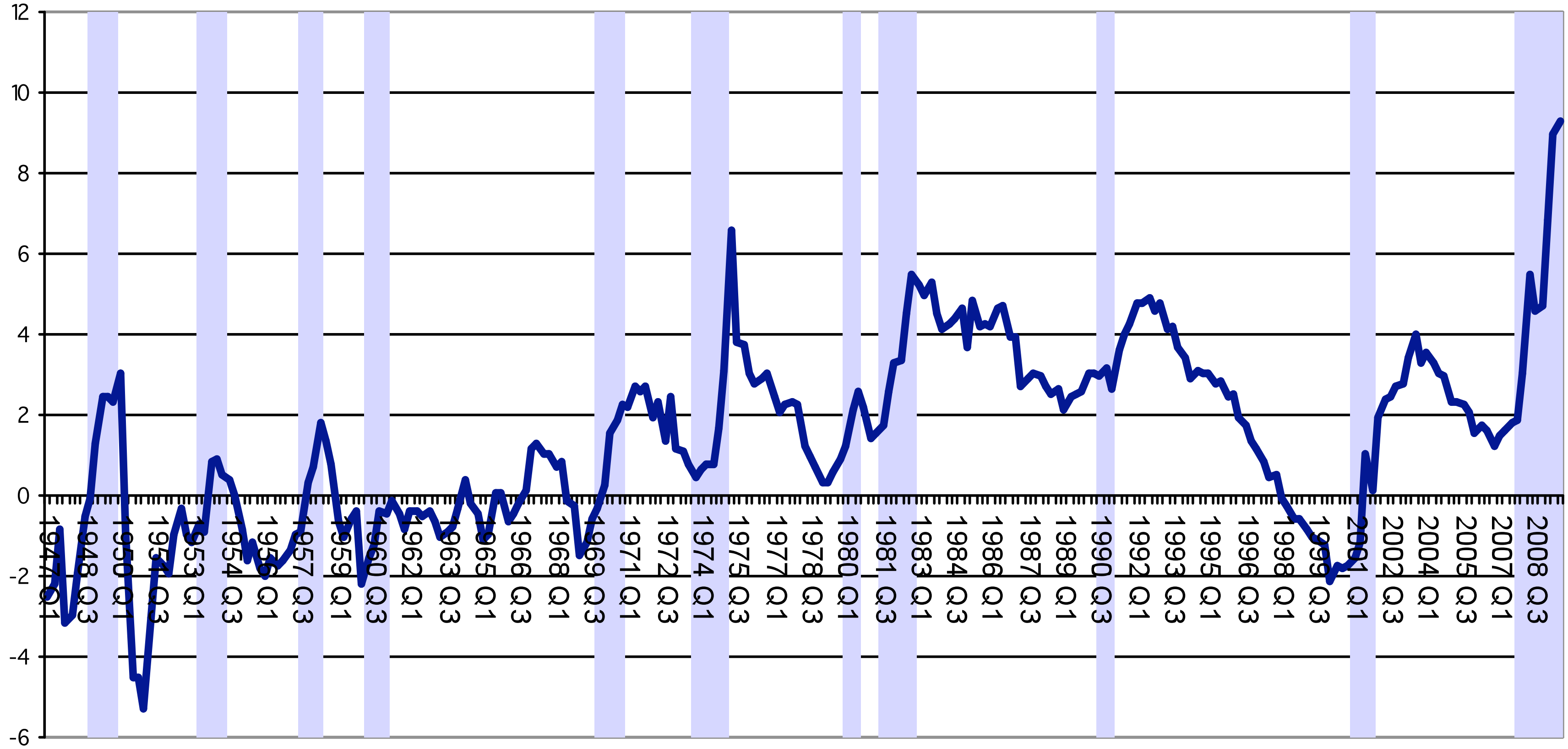
Deficits and Debt

- Government deficit mirrors what goes on in the non-government sector
  - If the non-government sector wants to net save the government balance automatically goes into deficit
- The Rogoff-Reinhart classification exposes their misunderstanding of what government "debt" is
  - An interest paying liability of the government and an asset for the private sector
- Bonds are merely a "savings" account at the Fed and hence it's not important whether there are takers for the debt

Federal Government Deficit/Surplus (% of GDP) and Recessions



Source: Bureau of Economic Analysis and National Bureau of Economic Research

Note: The Sign of the Deficit/Surplus is Reversed

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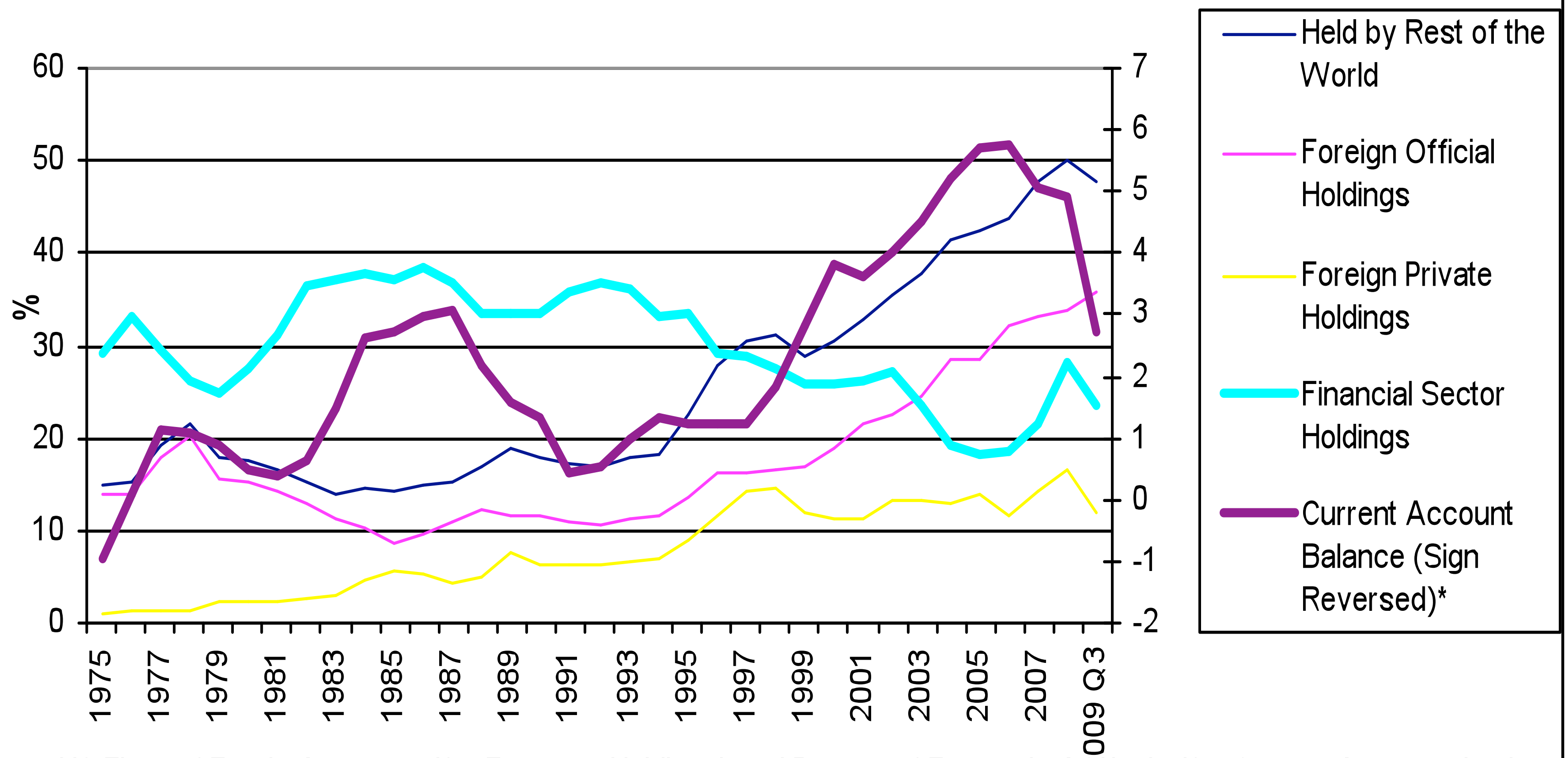
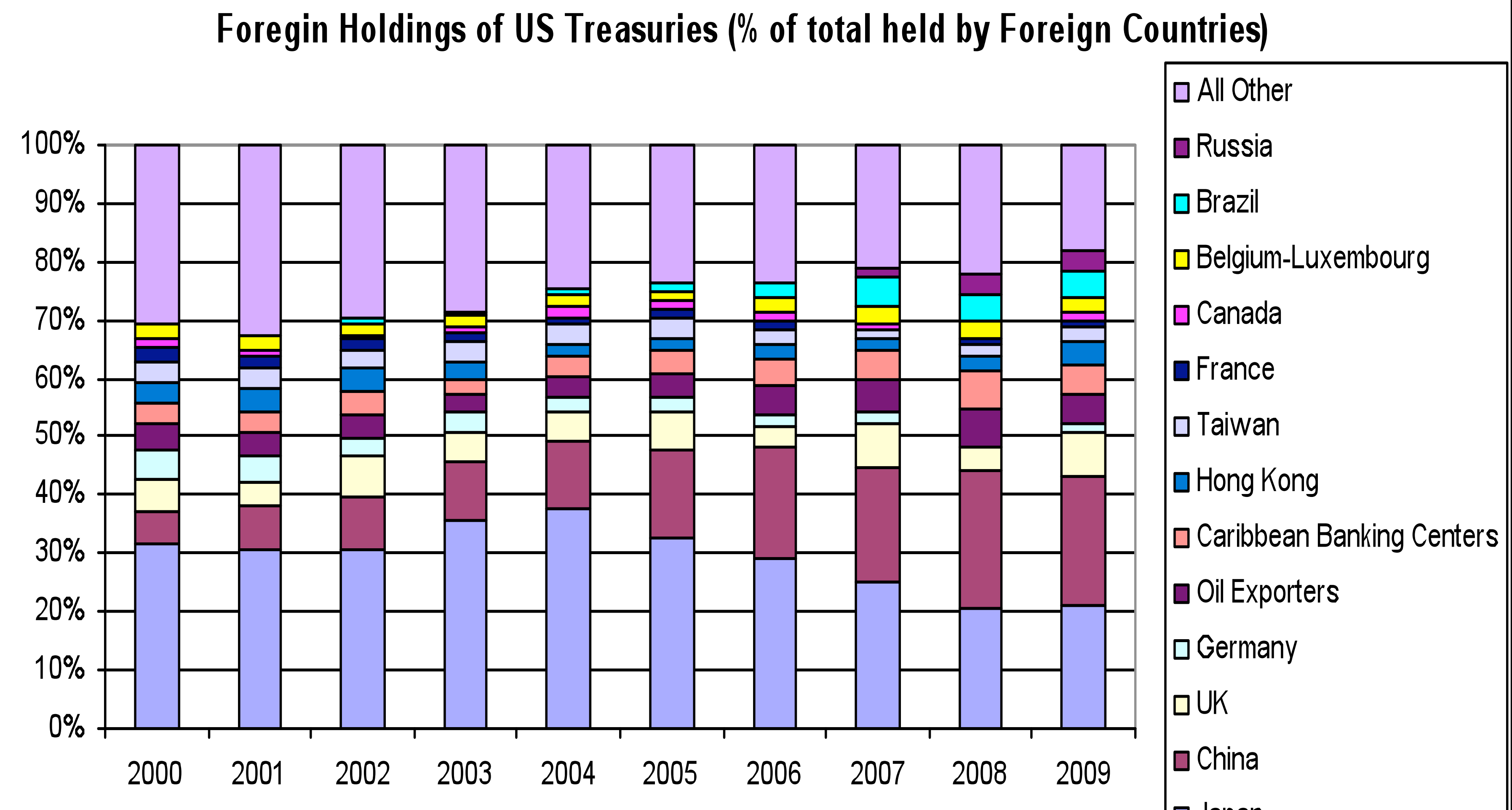
Treasury Security Holdings (% of Total Oustanding)



Source: US Flow of Funds Accounts (for Treasury Holdings) and Bureau of Economic Analysis (for Current Account data)

*Current account data is as of the end of 2009; treasury holdings data is as of 2009 Q3



Source: US Department of Treasury, November 2009 figures

Note: For some years the holdings of the selected countries have been insignificant, so they are included in the category "All Other"

Conclusions

- Reinhart and Rogoff research is not useful for expanding our knowledge about crises or effects of government debt and deficits
- In their book we can't find any defaults on domestic currency denominated debt with a floating currency
  - Even though they claim to have identified 70
  - Inflation is not default
- No mention of J.K. Galbraith or Minsky
- All we know after reading the book is "Yes, there have a lot of crises throughout history"

Functional Finance vs. Myth and Magic

- With nearly 10% unemployment (and a more broad measure of labor underutilization at 17%) the public debate is focused on the false problems

- Government deficit should be a means not an end in and of itself (to achieve high employment, to stabilize private balance sheets, etc.)
  - Fiscal sustainability should be defined in terms of employment and not some arbitrary number

- There are no magic numbers applicable to all countries or different monetary regimes in different times

Sovereign governments are never financially constrained

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