Fiscal Constraints & the Economy: 4 Politically Incorrect Questions

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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?

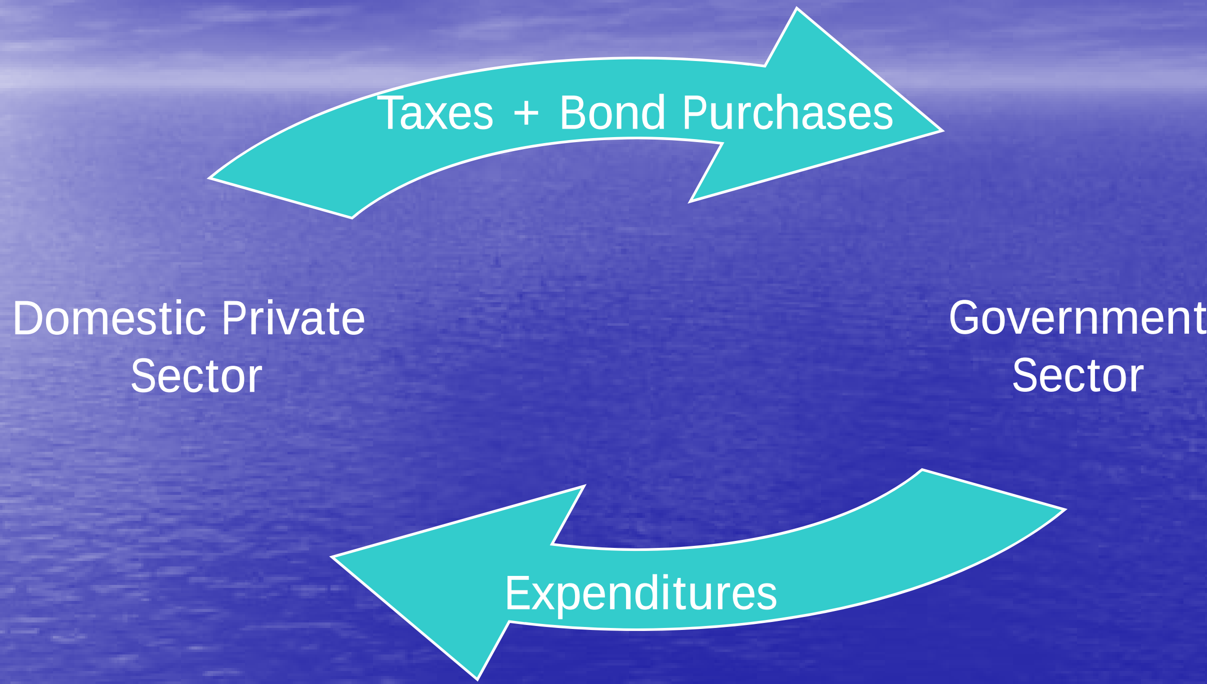
The Government Budget Constraint

G = T + d(D) + d(M)

G = Government Expenditures
T = Tax Revenues
D = Government Debt Outstanding
M = Money Stock

Solvency defined:
PV of future (T-G) = or > initial D

Government Budget Finance



- 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

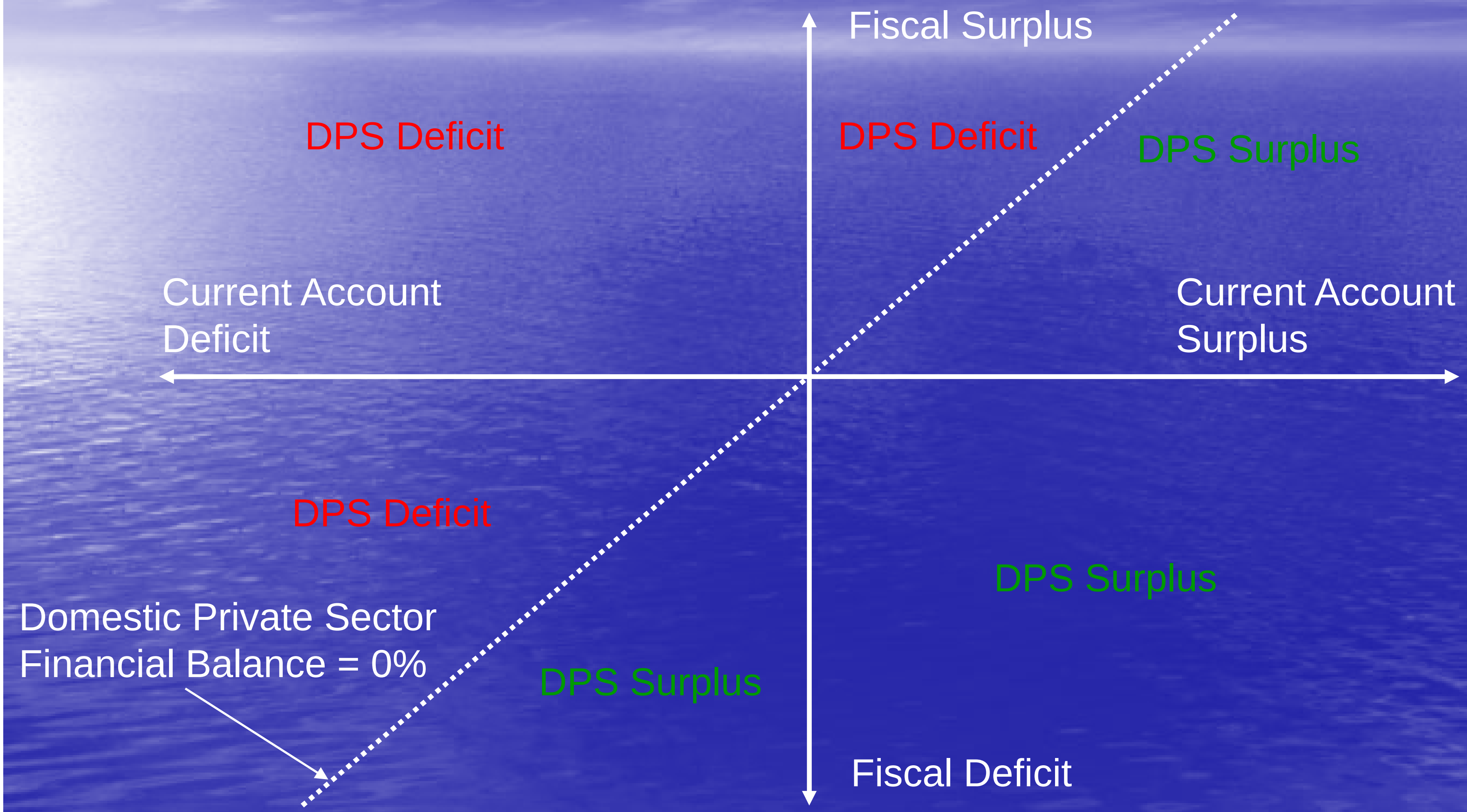
Change in one sector financial balance implies changes to other two

The Financial Balance Approach

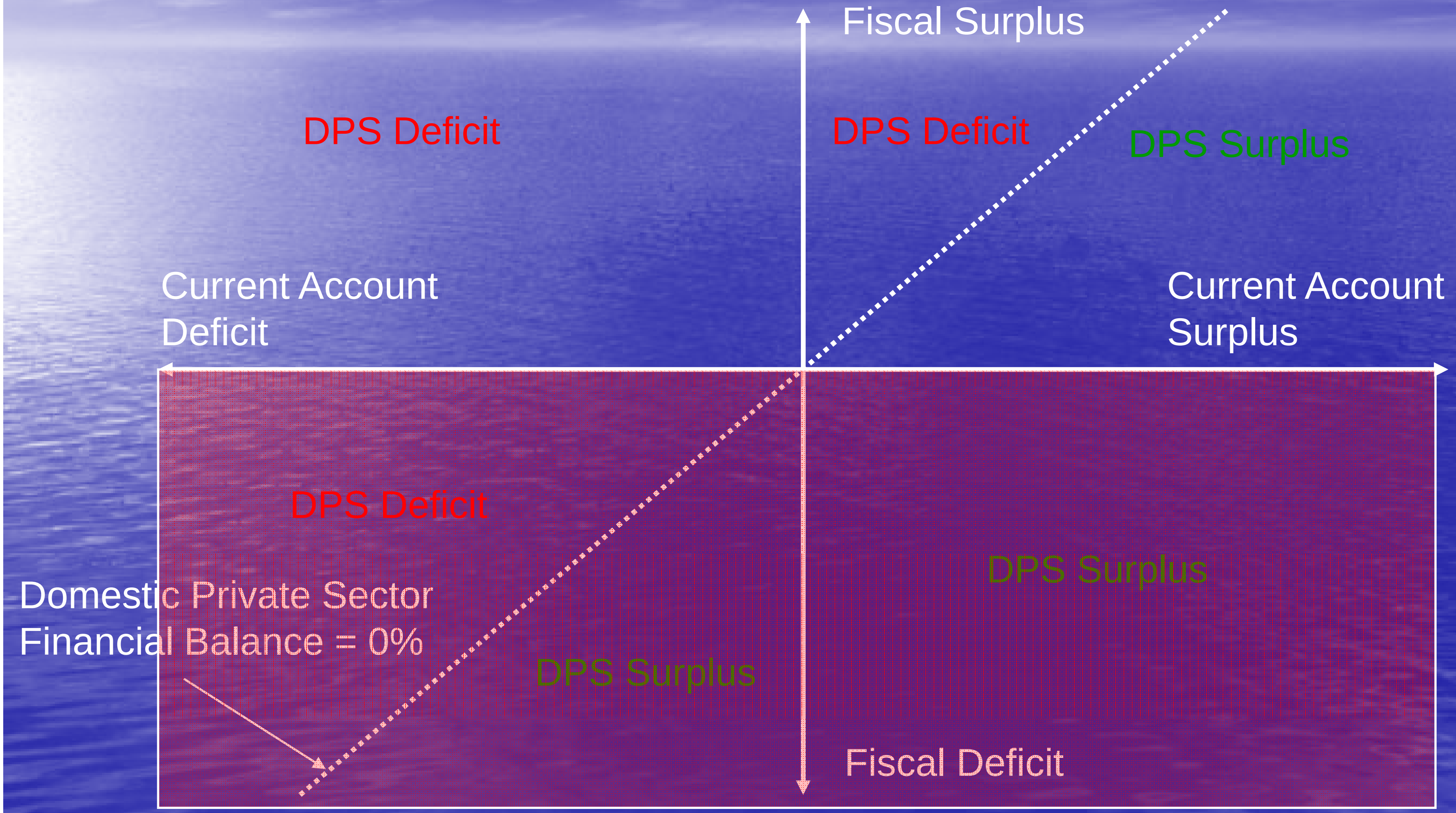
- Changing the FB for one sector will have implications for the remaining sectors (range of possible outcomes)
- For DPS to net save, need a) fiscal deficit, or b) trade surplus, or more generally, CUB > GFB

3 Sector Financial Balances Map

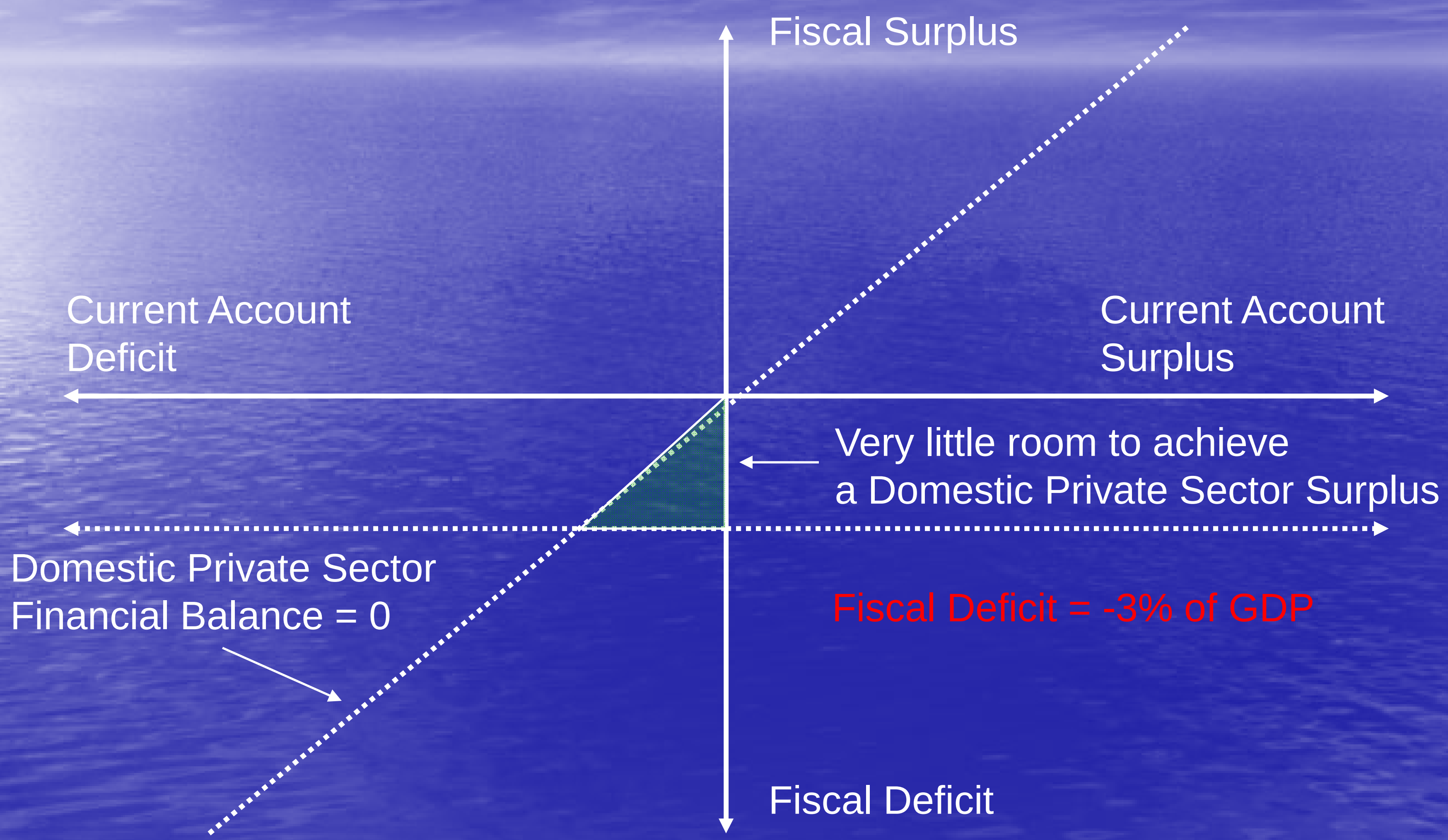
Domestic Private Sector Financial Balance = Current Account Balance – Fiscal Balance



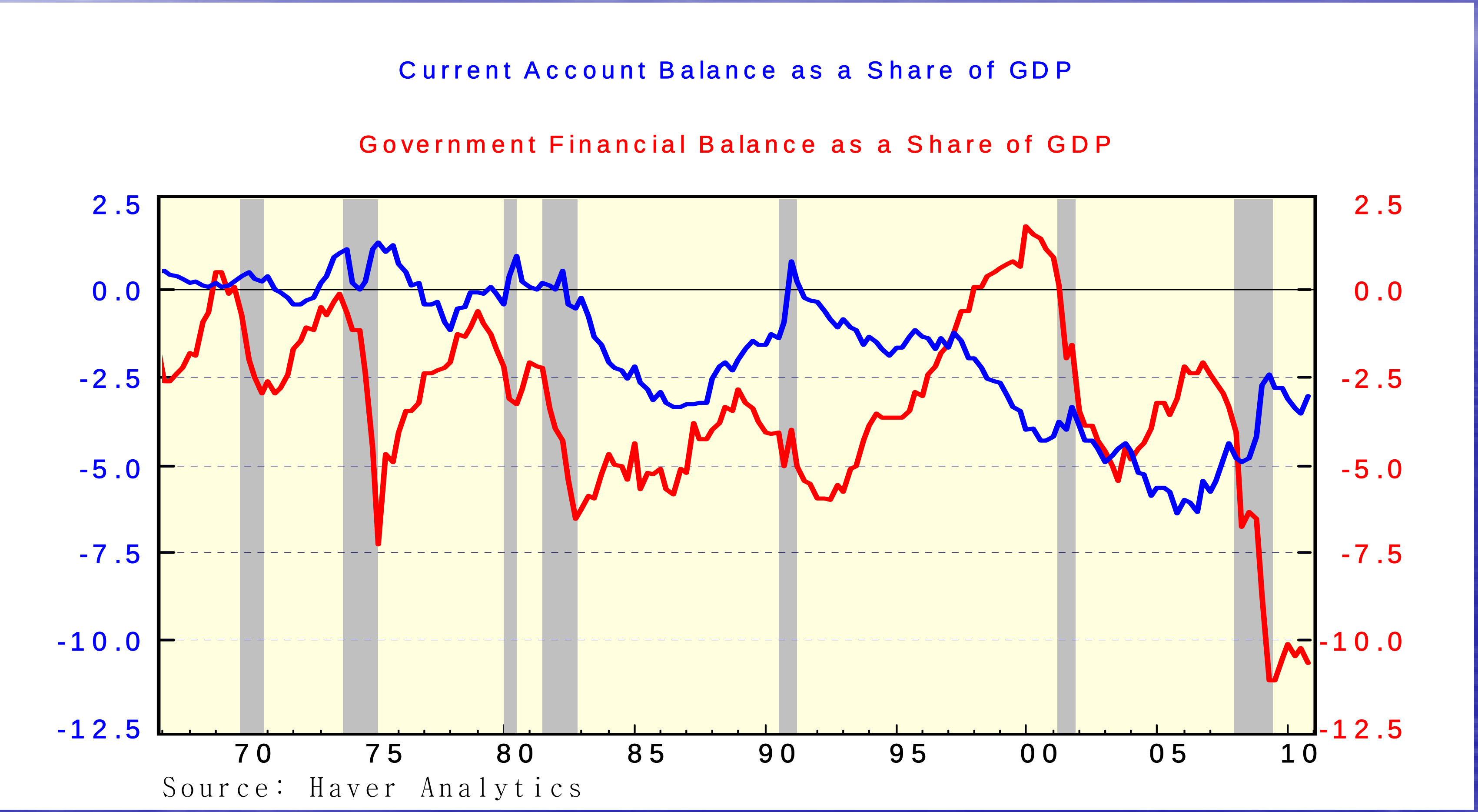
Balanced Budget Constraint



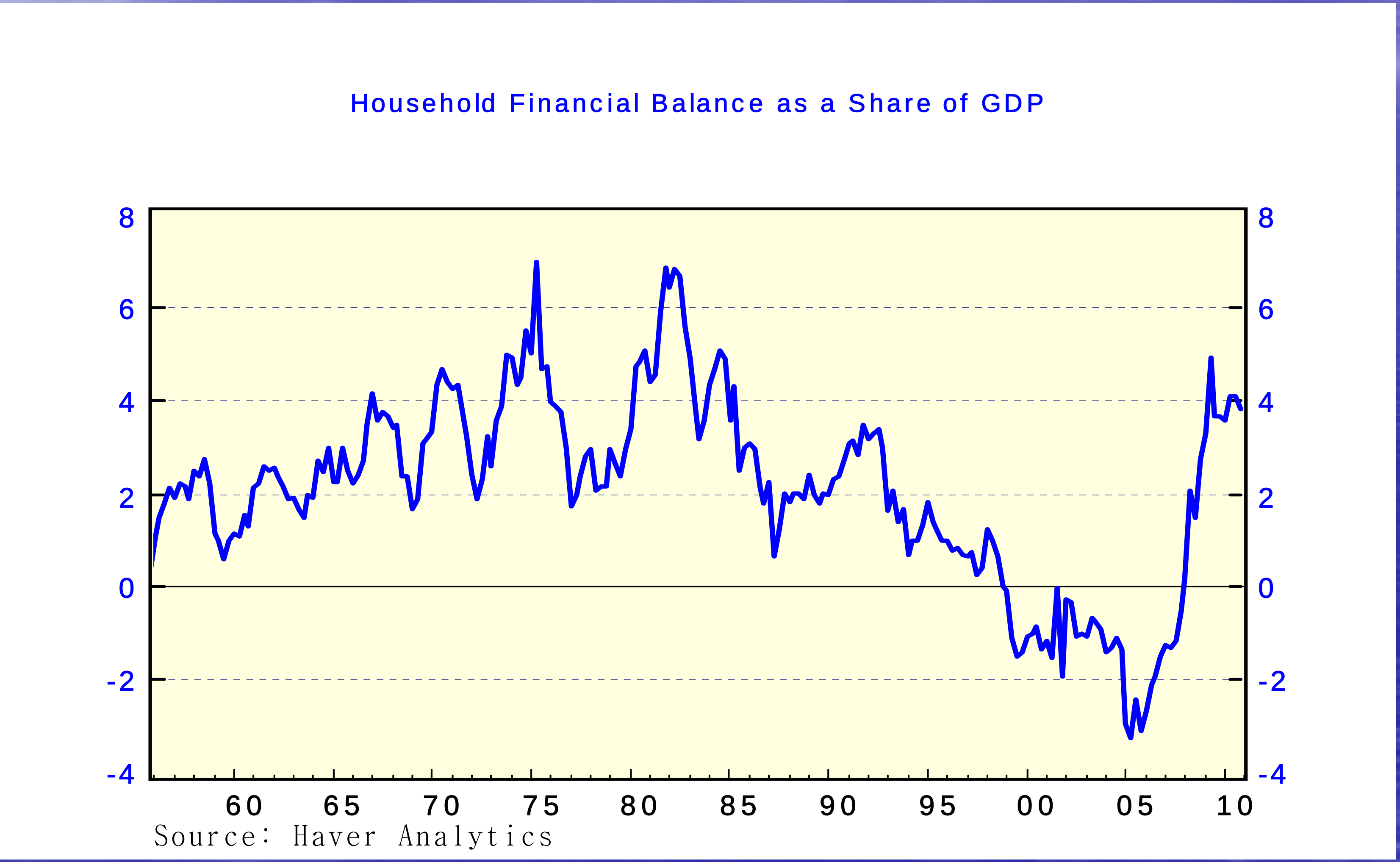
The EMU Triangle



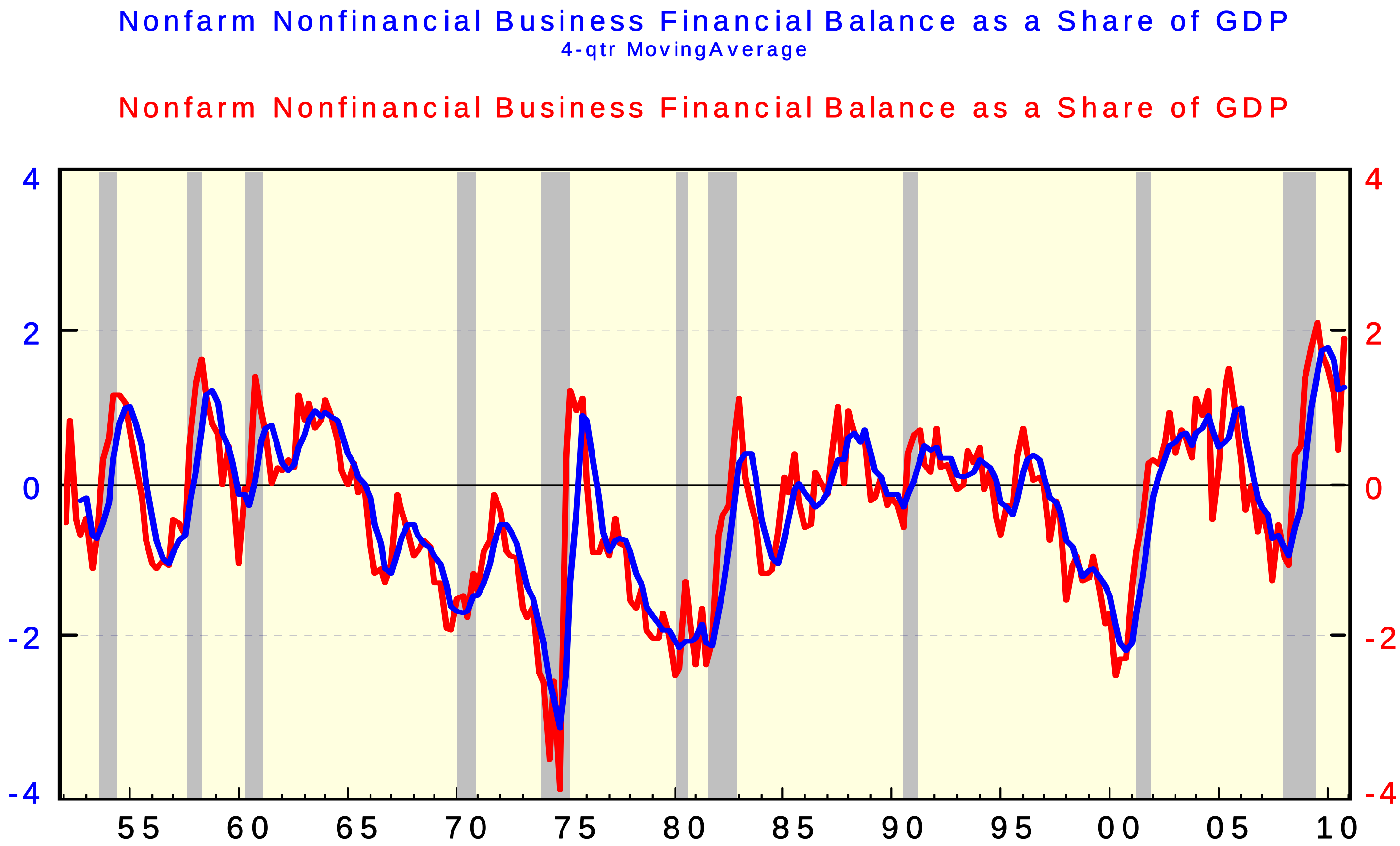
Fiscal Deficit > Current Account Deficit = Large Private Sector Financial Surplus



US Households in a Net Saving Mode

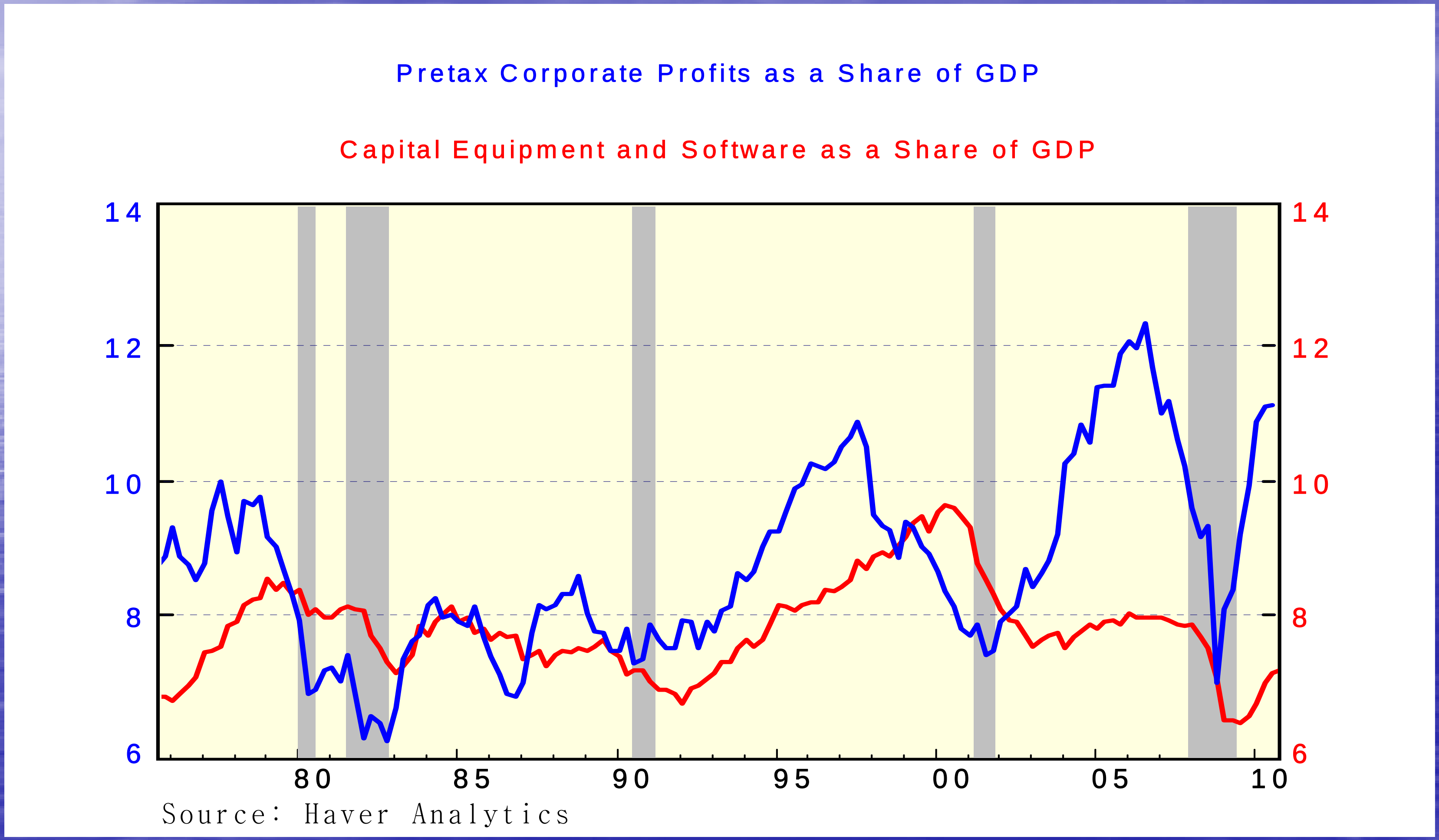


Business Sector Net Saving

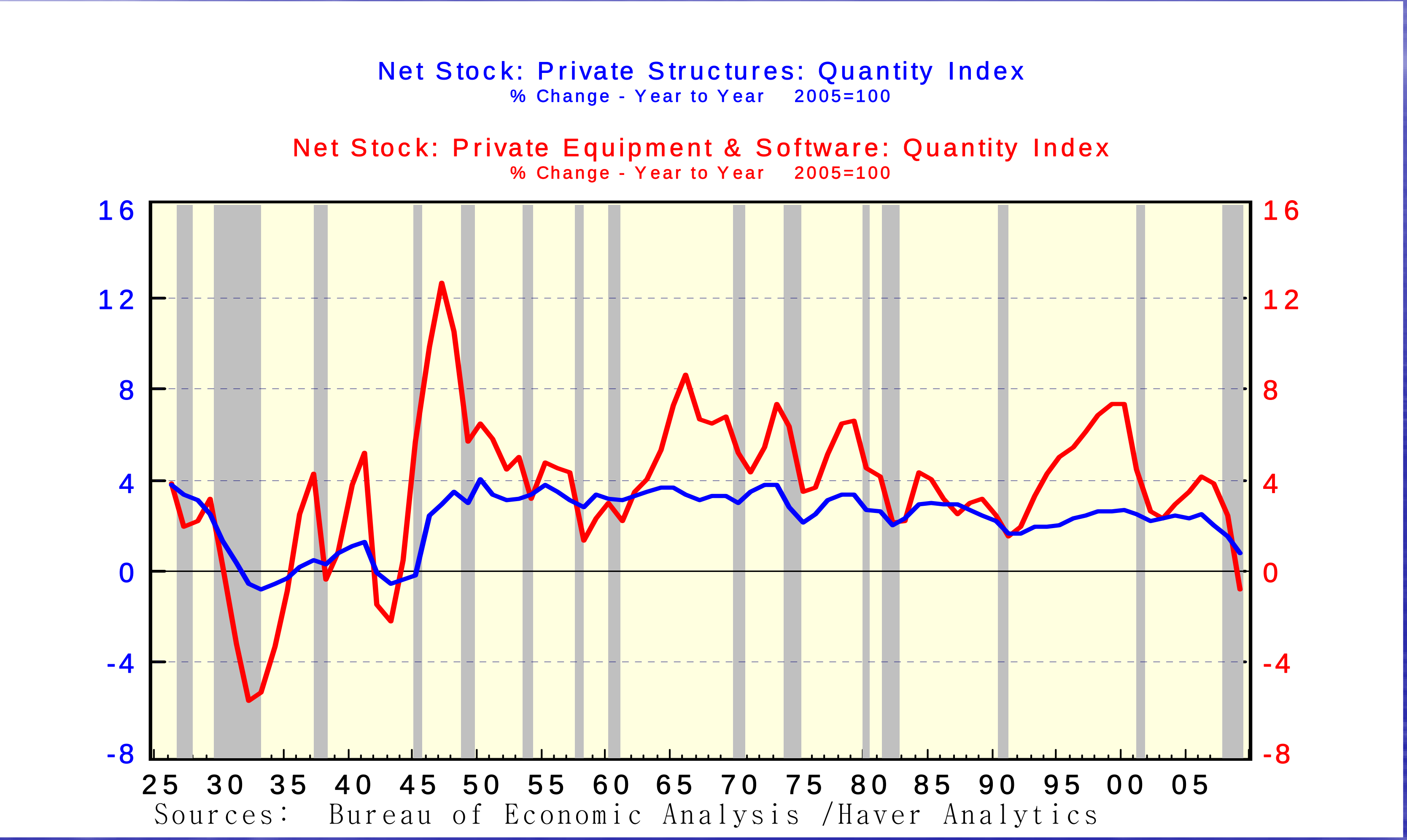


Source: Haver Analytics

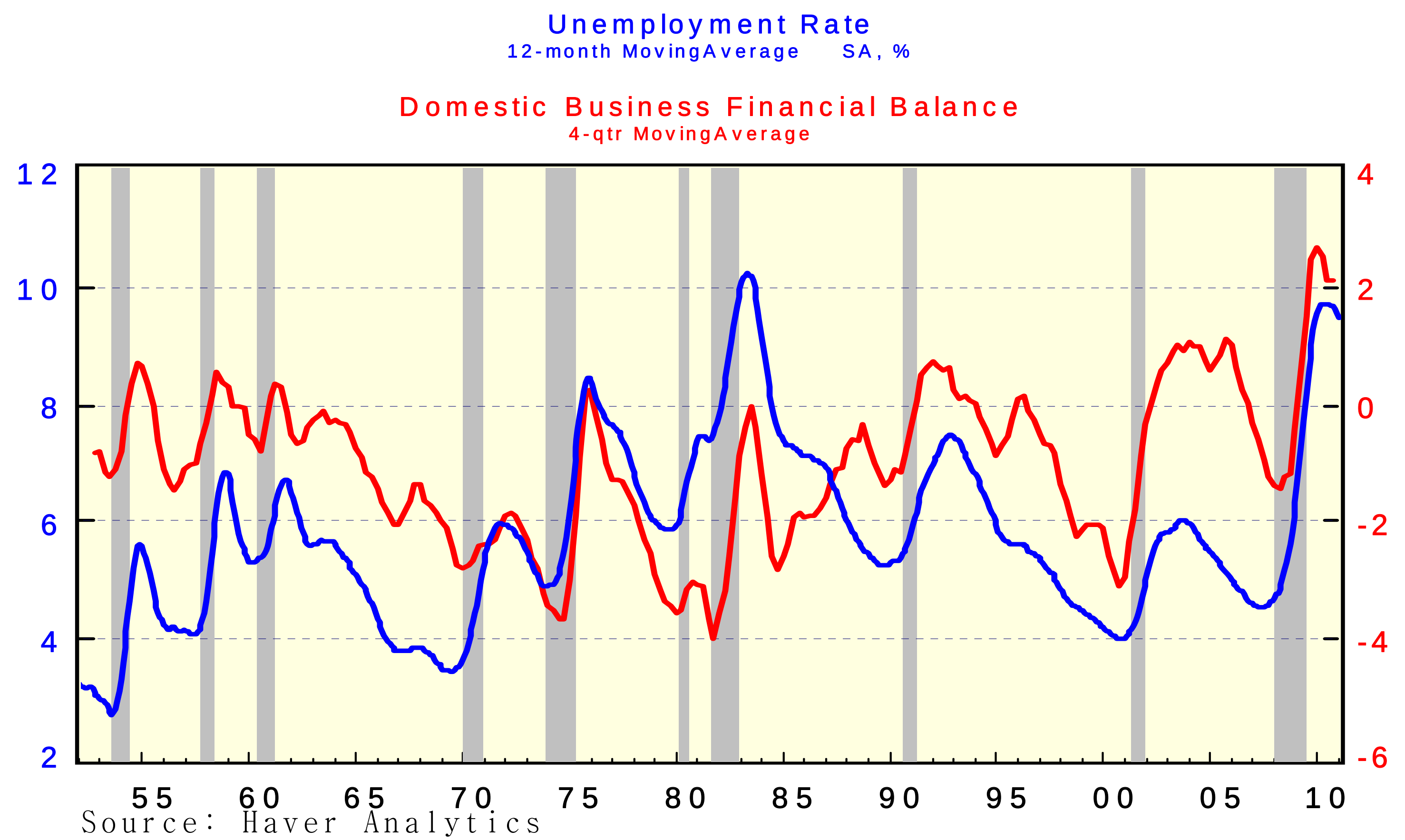
Profit Margins Soar, Investment Share Low



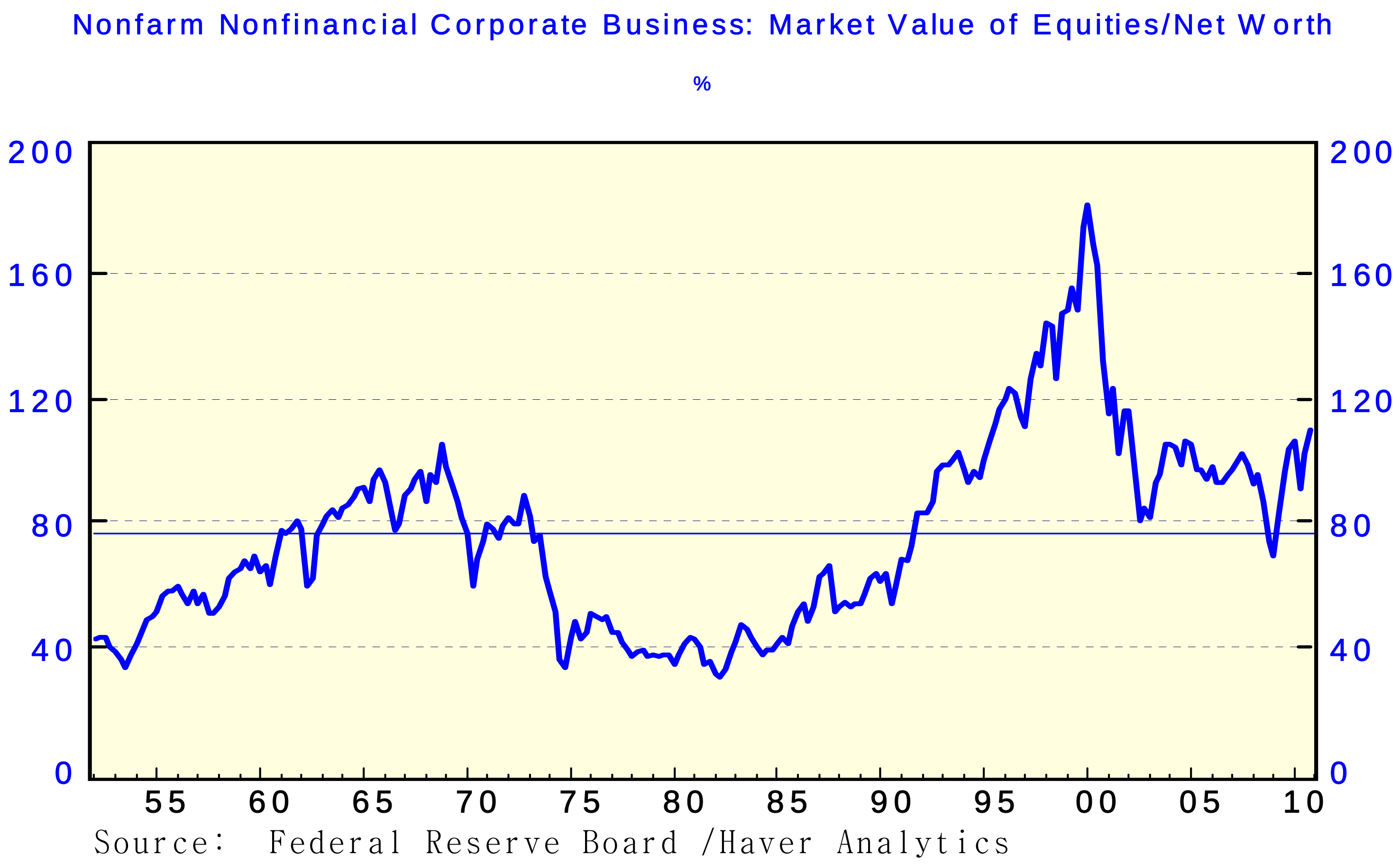
US Capital Stock on a Diet: Financial Incentive Constraint?



US Business Financial Balance and the Unemployment Rate



Tobin's Q: Signal to Reinvest, not M&A



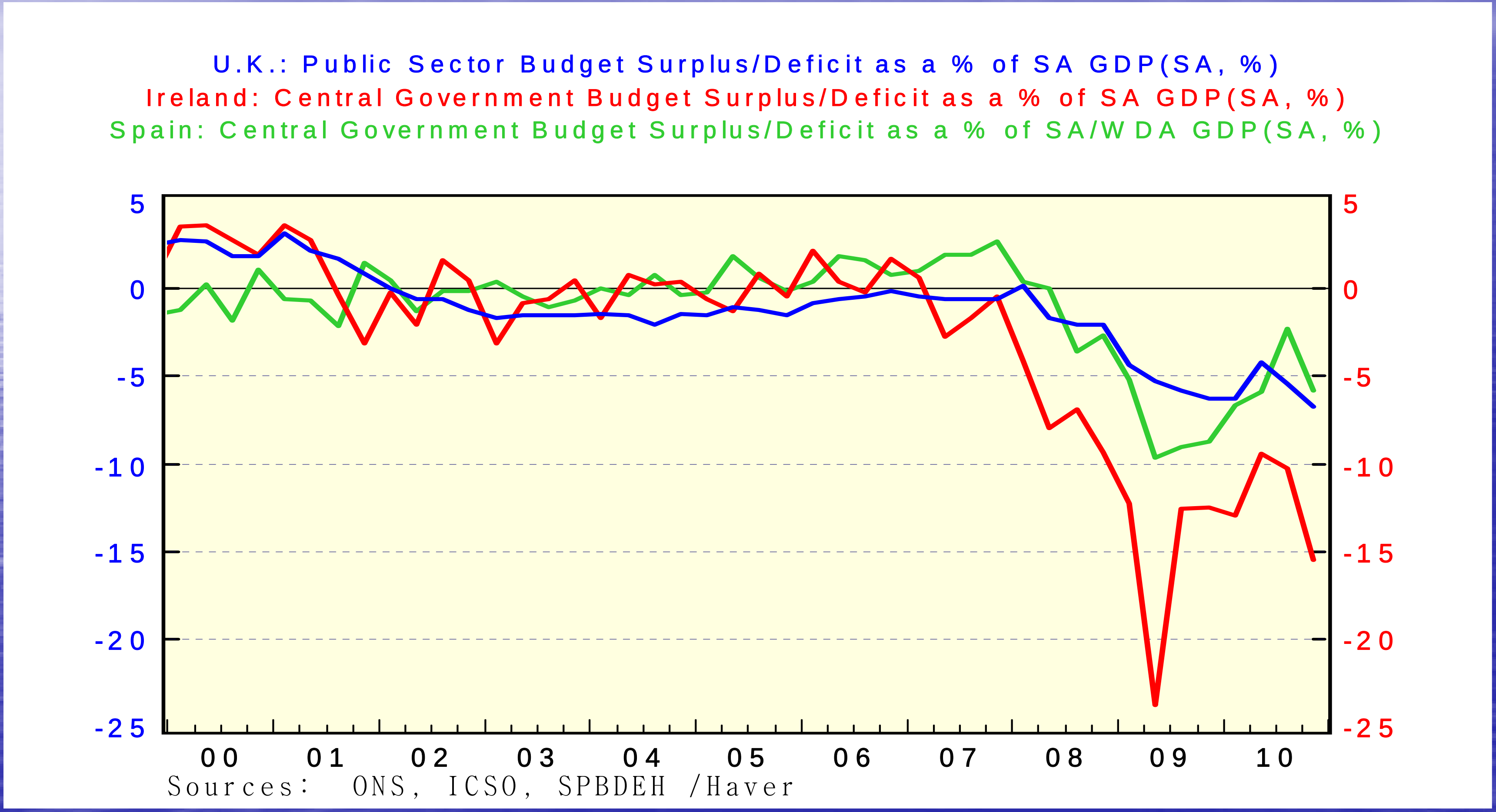
Corporate Reinvestment Rates

- 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

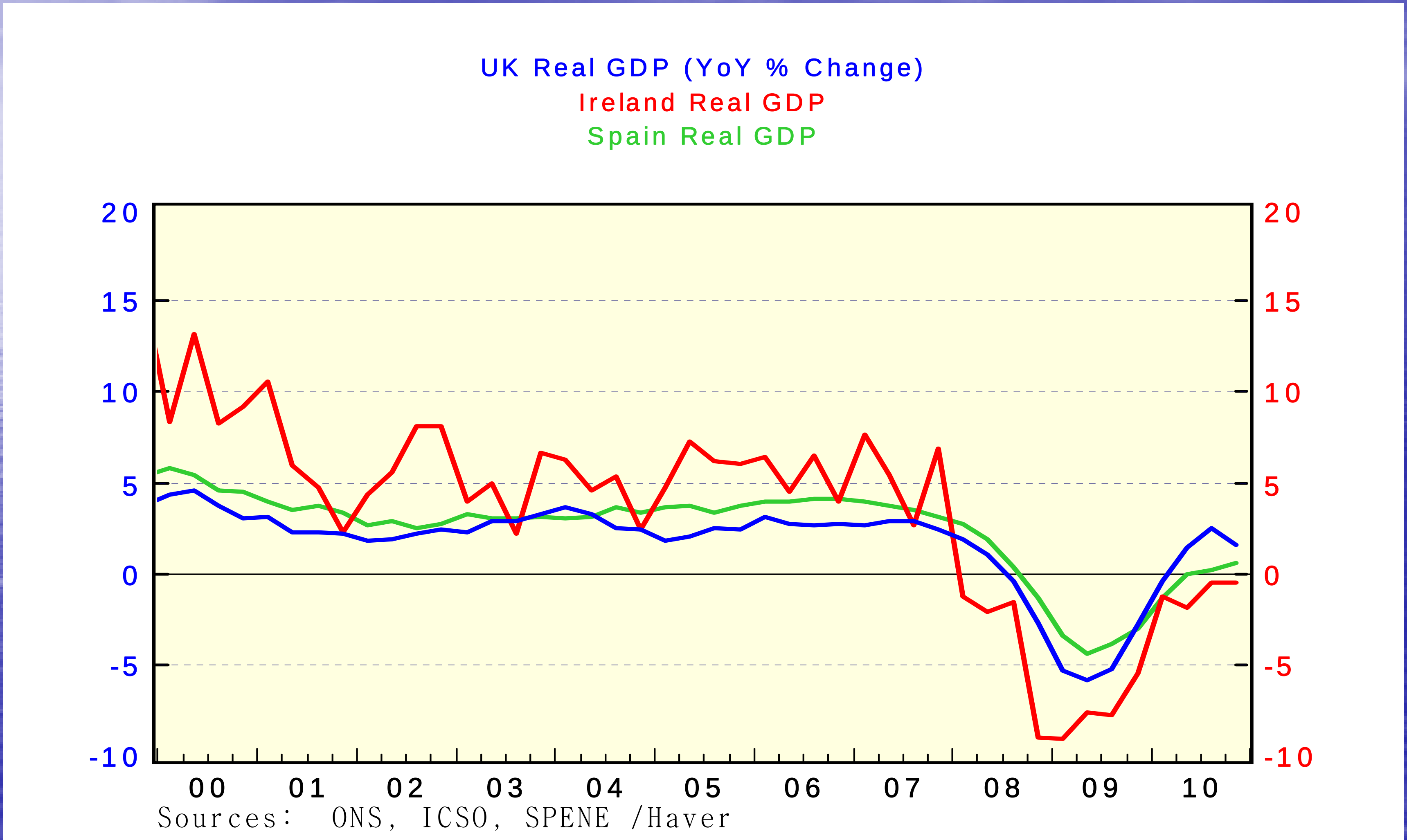
Expansionary Fiscal Consolidations

- 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

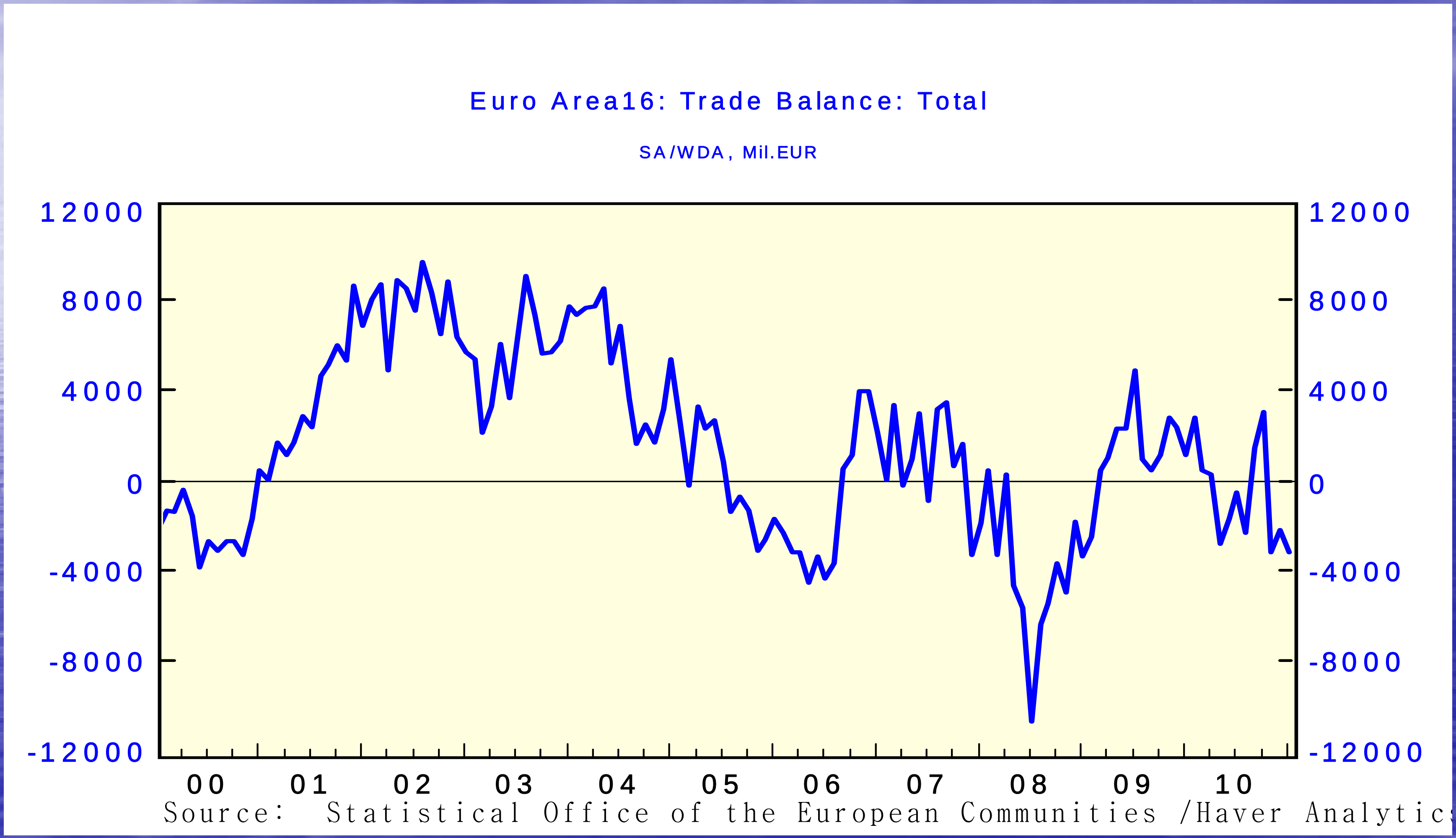
Fiscal Consolidation...or rediscovering the Paradox of Public Thrift?



Expansionary...or Double Dip?



EU Trade Balances Not Helping



Conclusions

- 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