

# 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

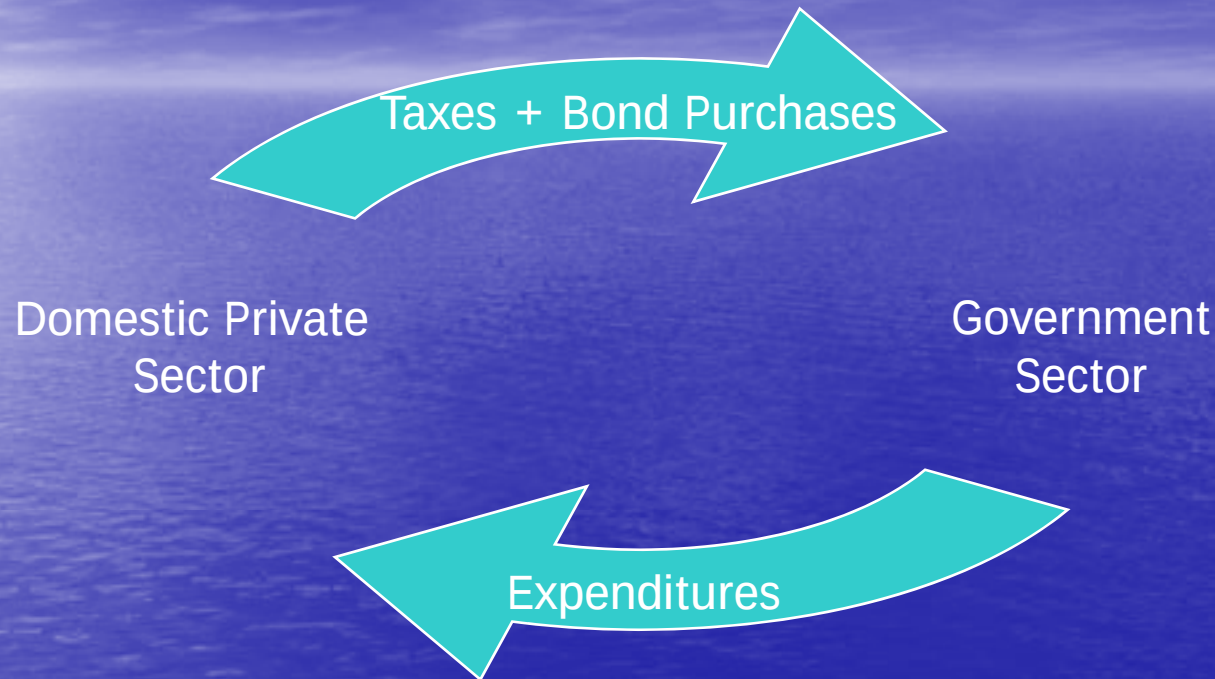
M = Money Stock

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 (+, =, -):

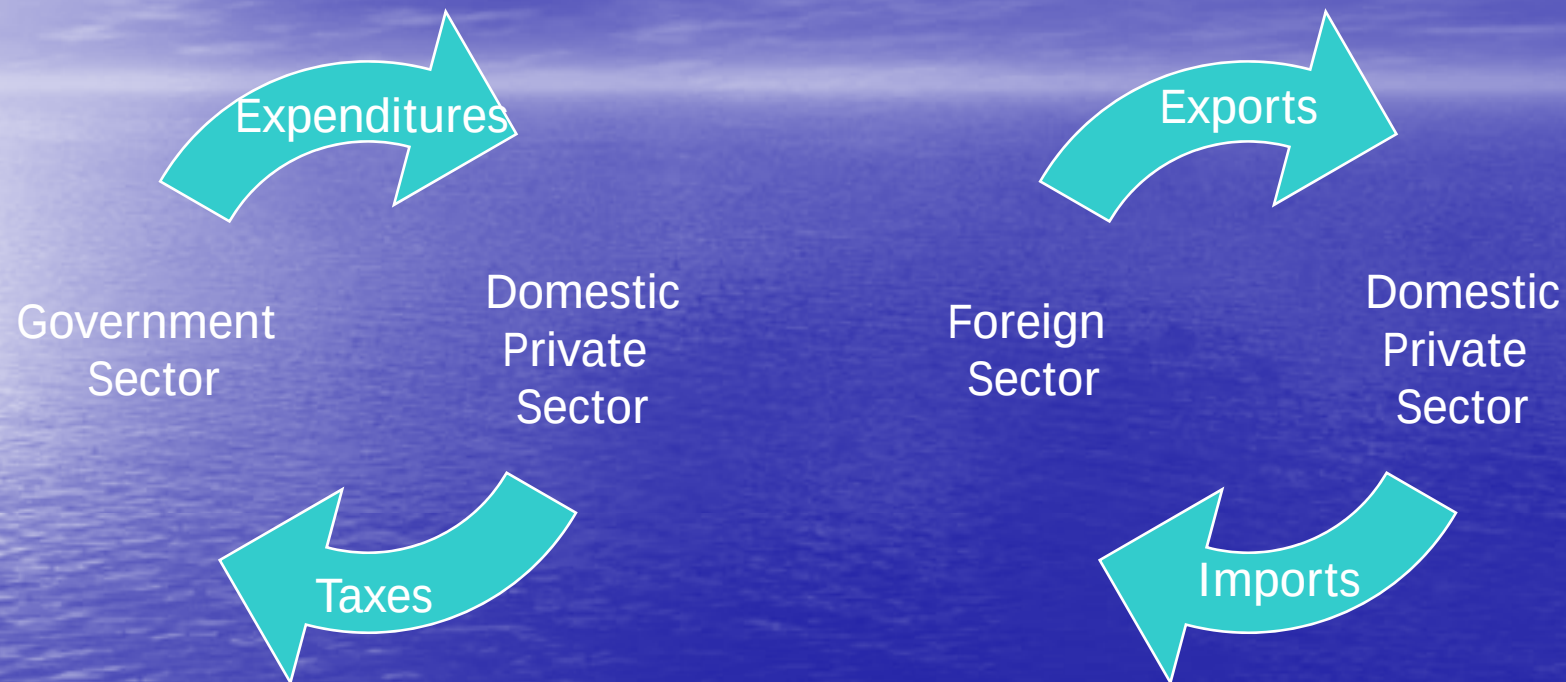
- Government FB =  $T - G$
- Foreign FB =  $M - X$ , (or inverse of Current Account Balance)
- Domestic Private Sector FB =  $(Sh + Sb) - (Ir + Inr)$

$DPSFB + GFB + FFB = 0$  (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

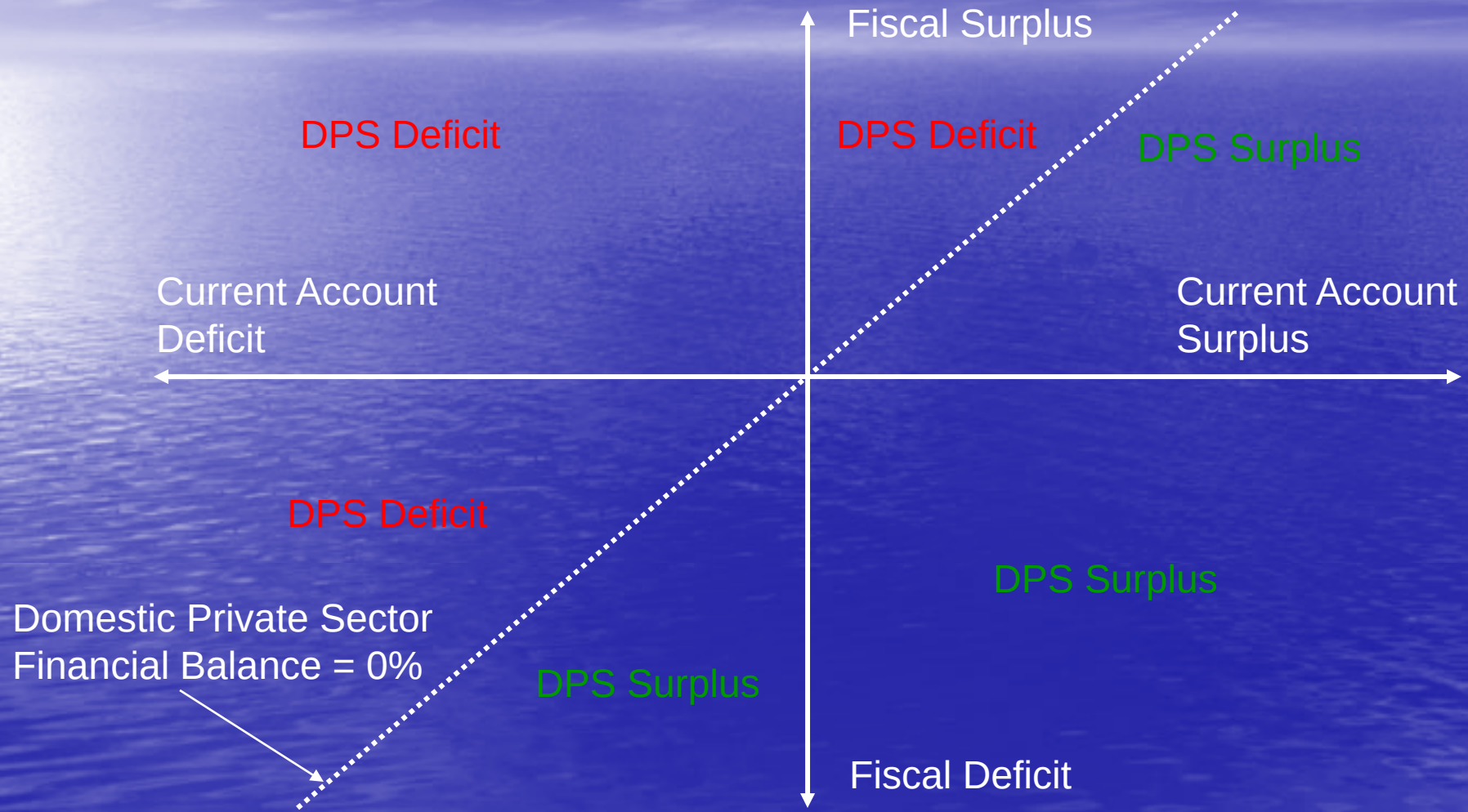


- Changing the FB for one sector will have implications for the remaining sectors (range of possible outcomes)
- For DPS to net save, need a) fiscal deficit, or b) trade surplus, or more generally,  $CUB > GFB$

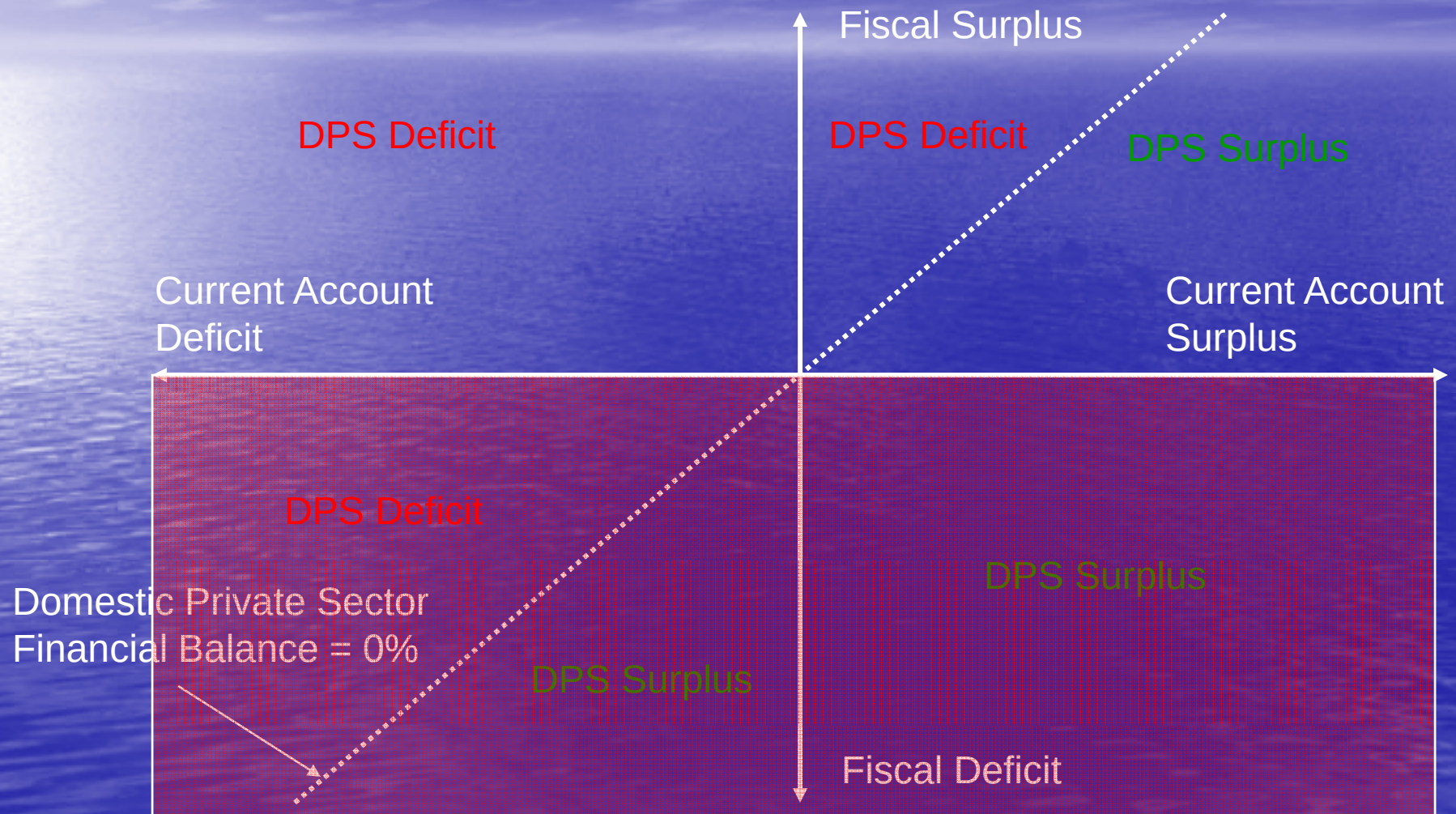


# 3 Sector Financial Balances Map

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

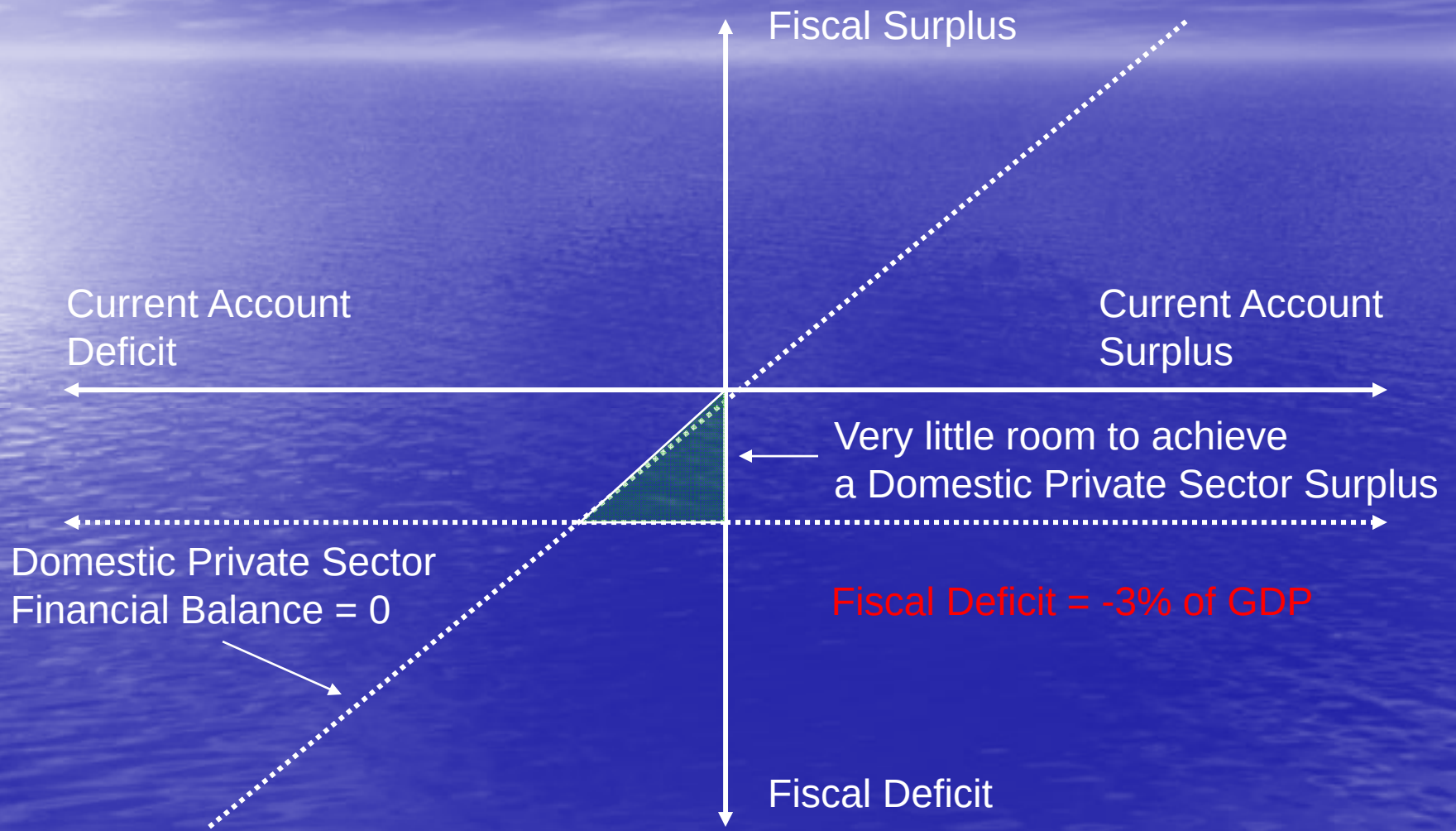


# Balanced Budget Constraint



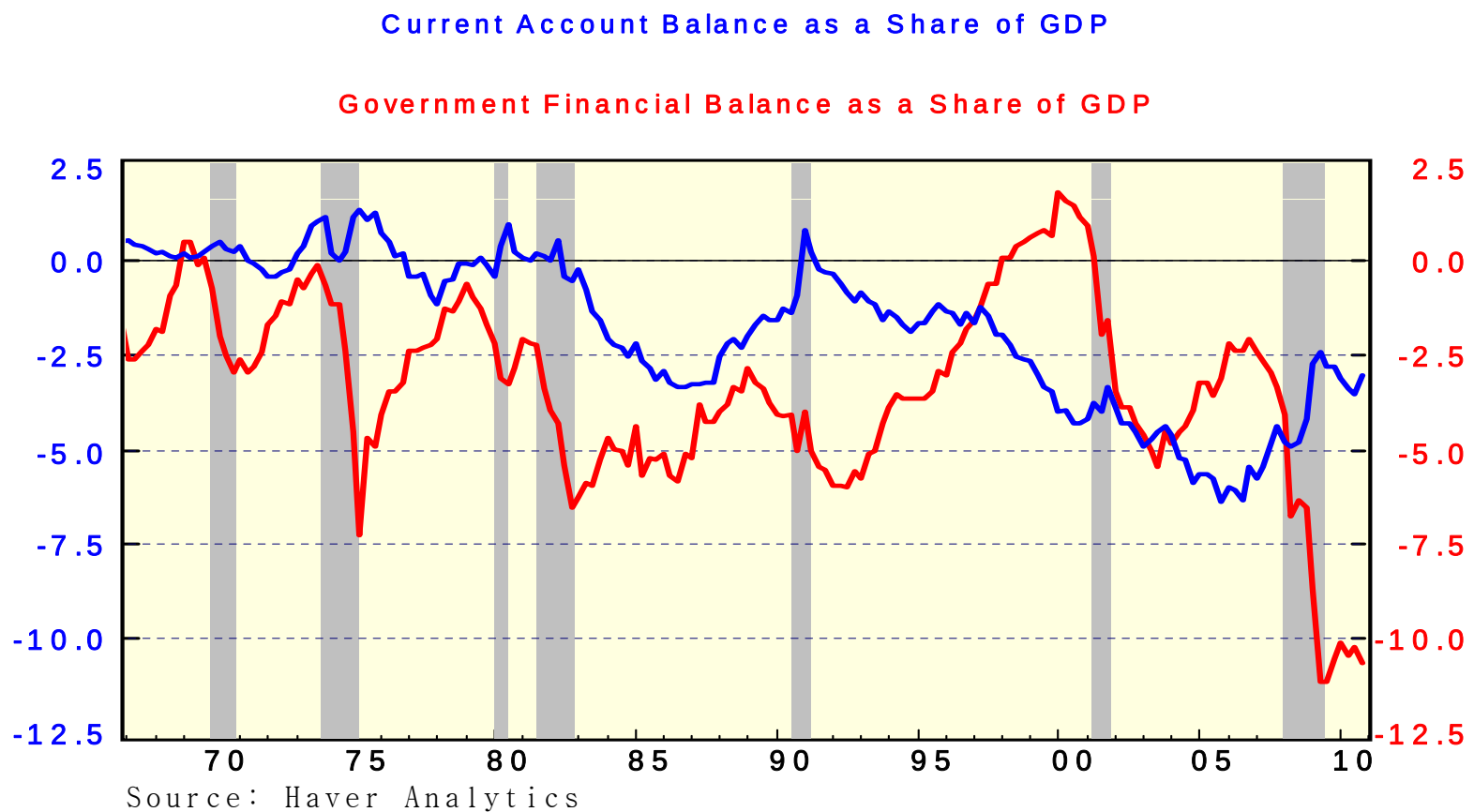


# The EMU Triangle





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



# US Households in a Net Saving Mode

Household Financial Balance as a Share of GDP

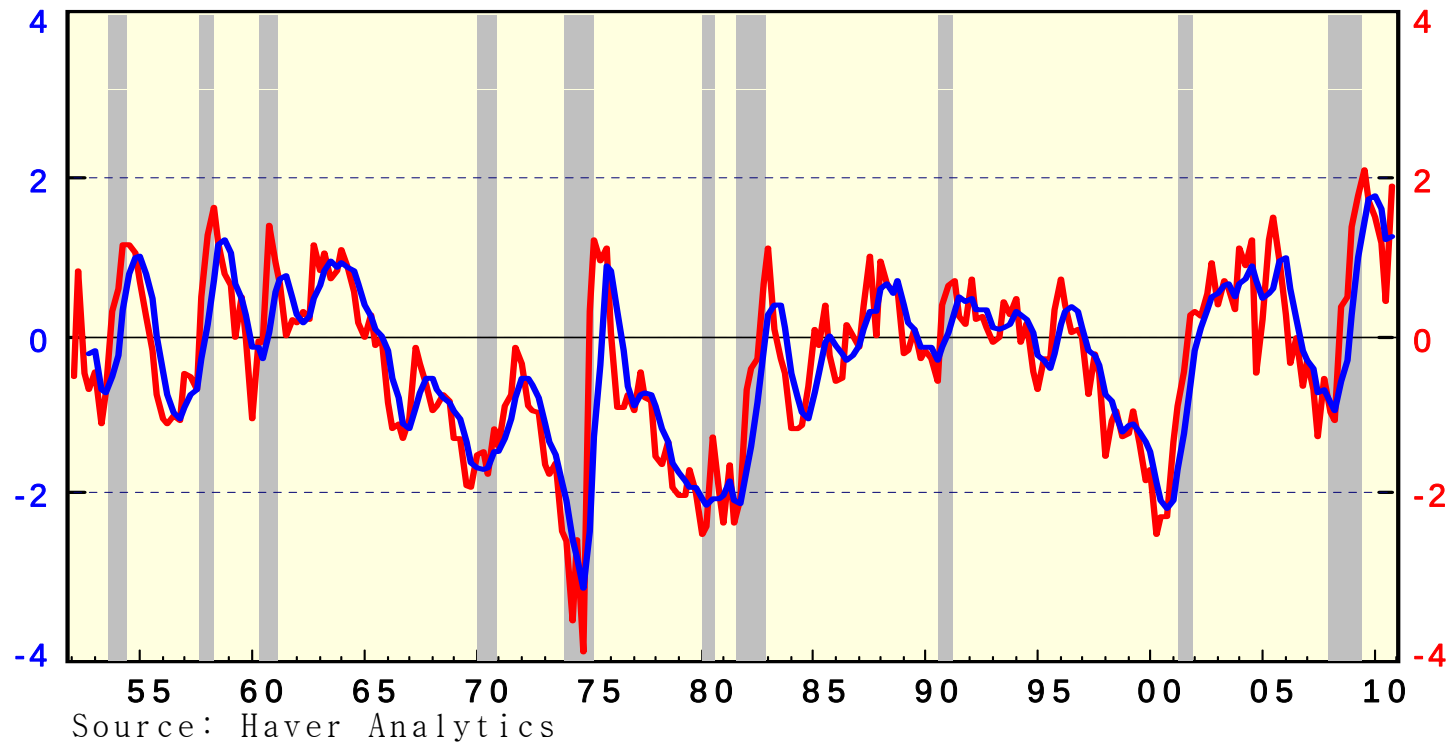


Source: Haver Analytics

# Business Sector Net Saving

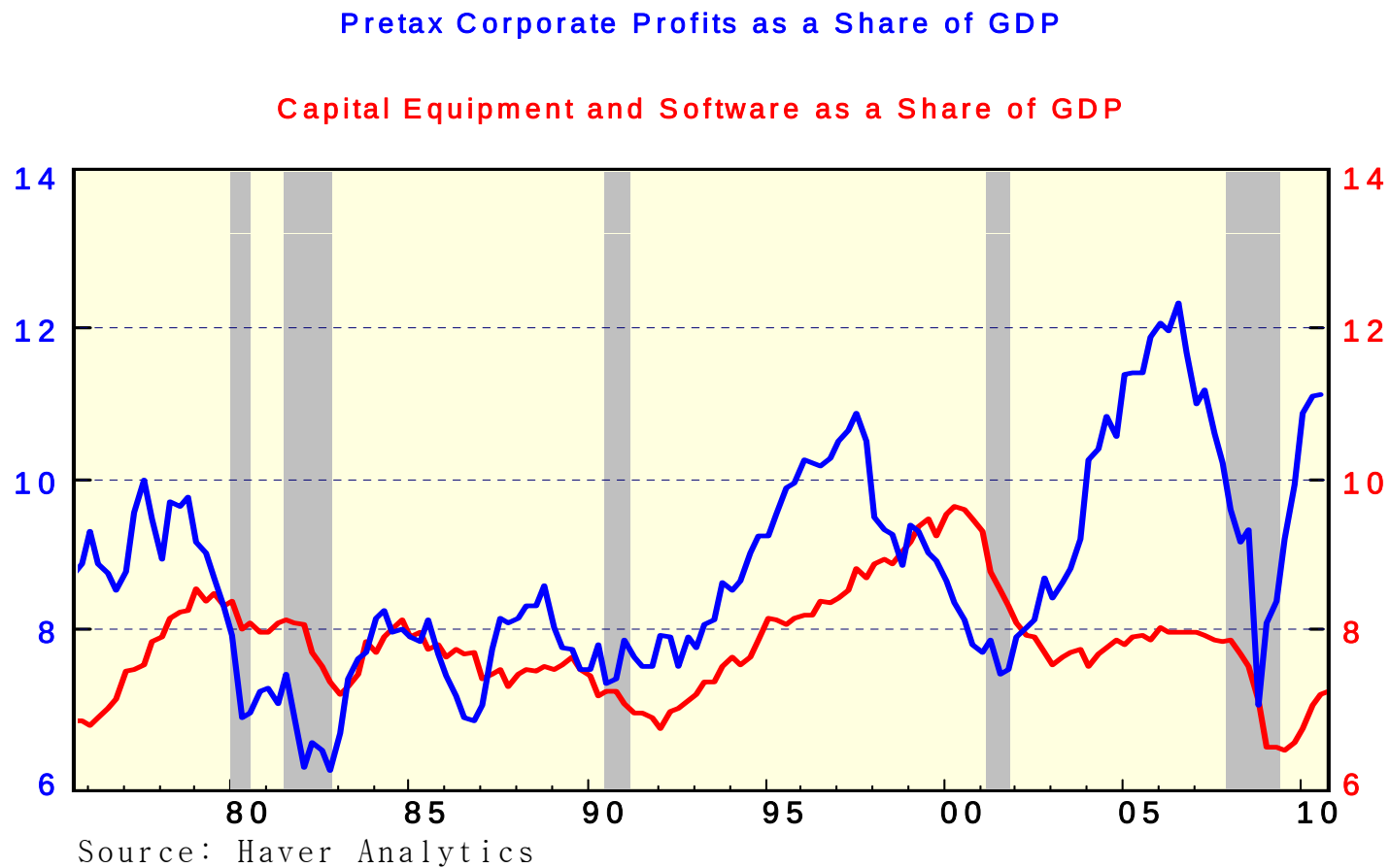
Nonfarm Nonfinancial Business Financial Balance as a Share of GDP  
4-qr MovingAverage

Nonfarm Nonfinancial Business Financial Balance as a Share of GDP

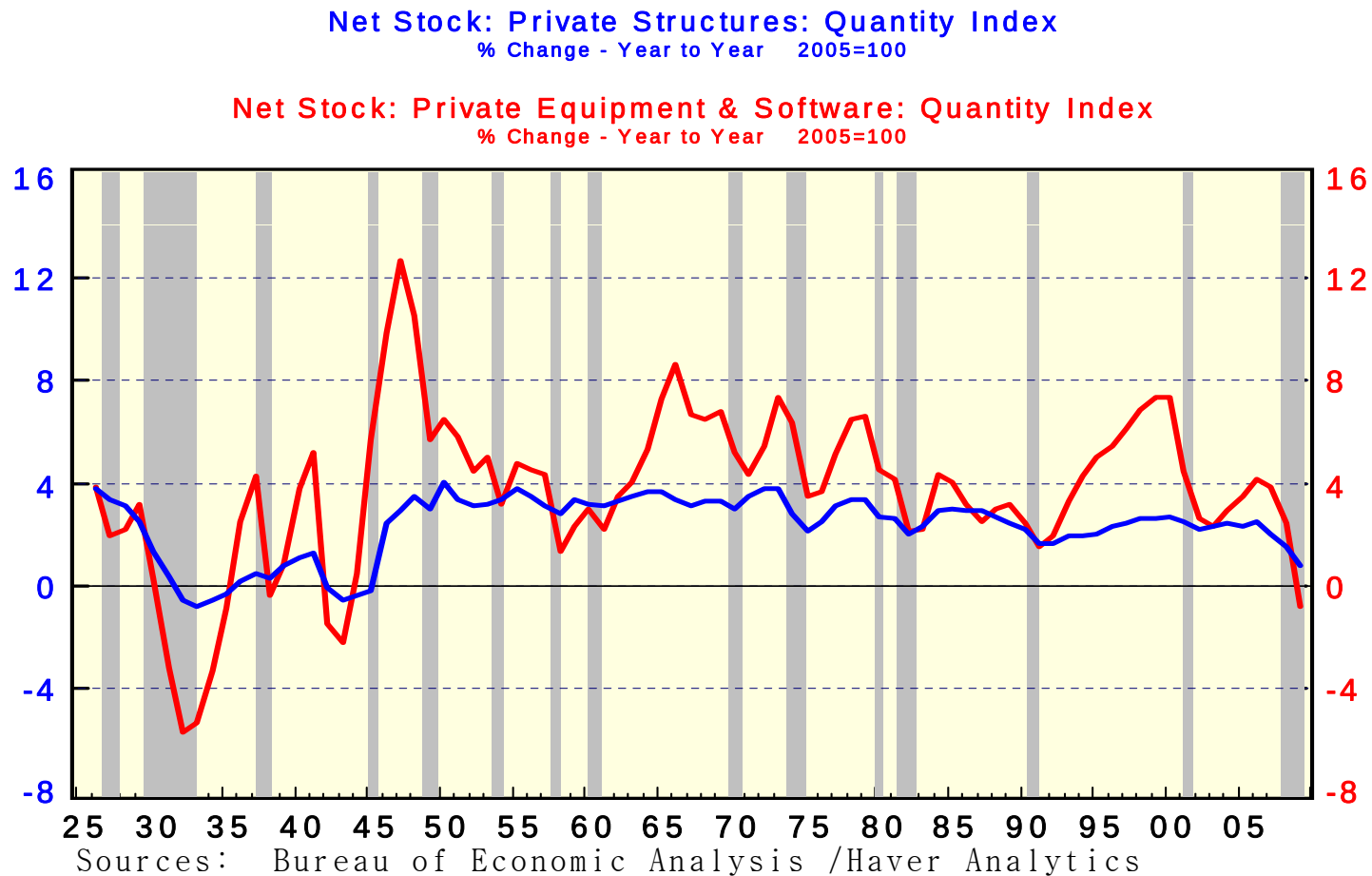




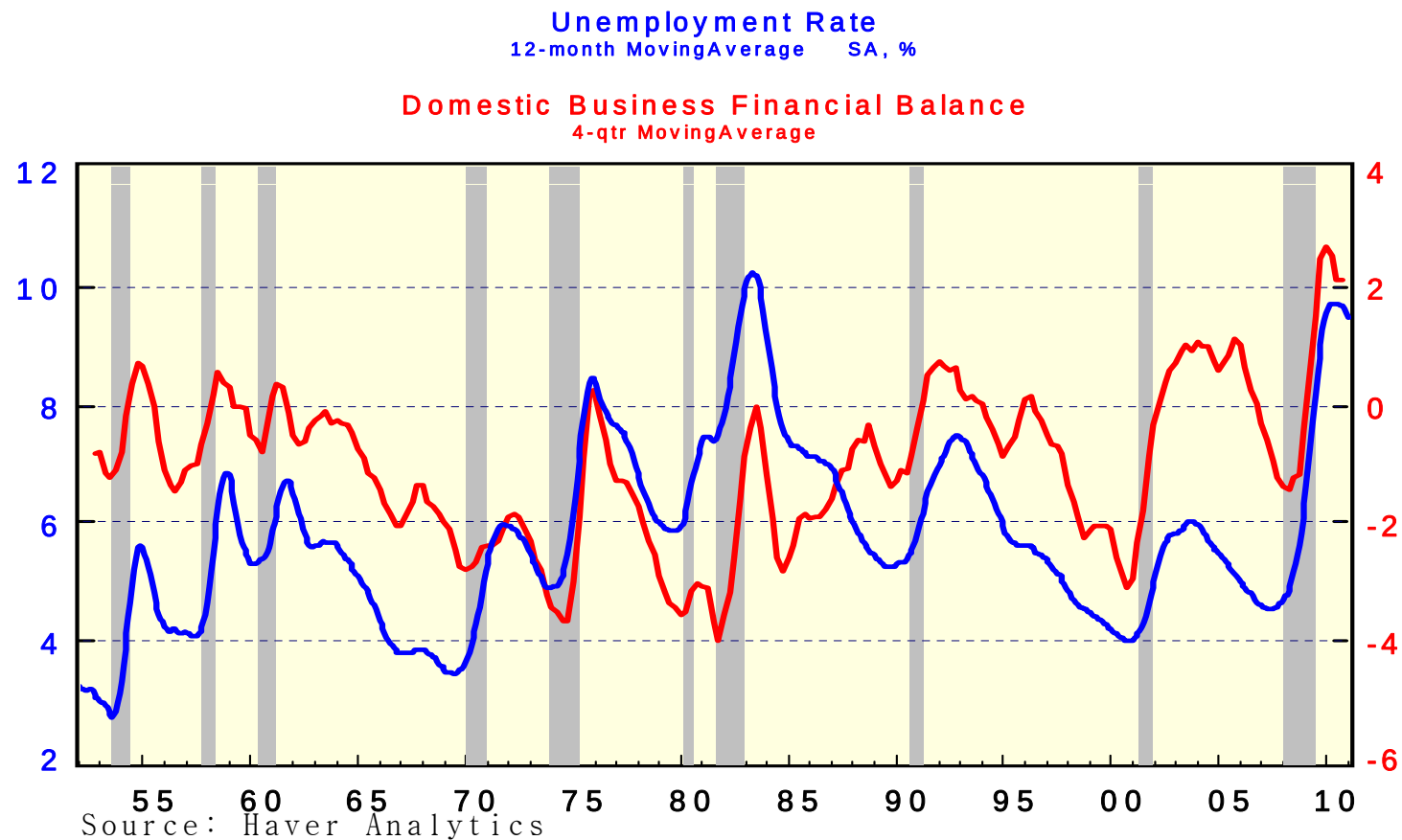
# Profit Margins Soar, Investment Share Low



# 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

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



Source: Federal Reserve Board /Haver Analytics

# Corporate Reinvestment Rates

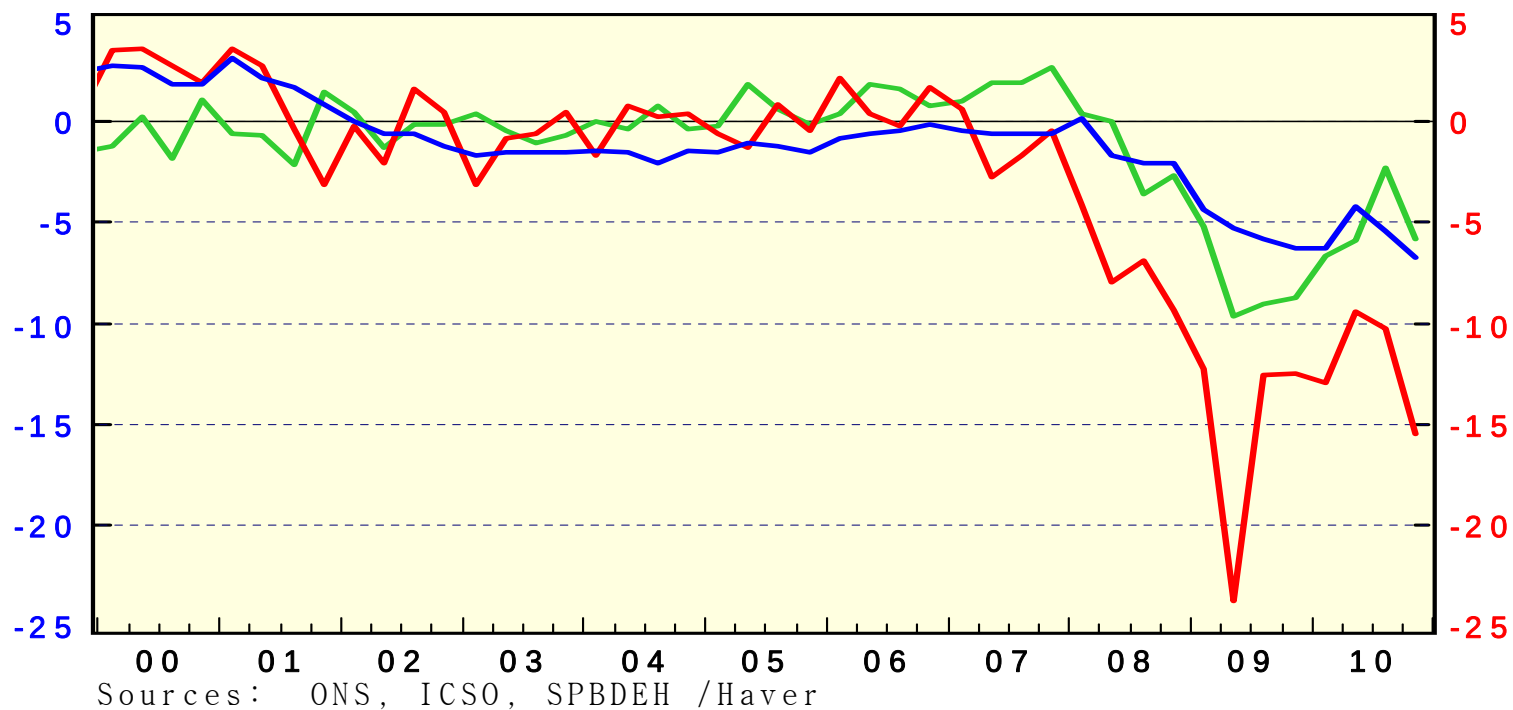
- Incentive structures for managers and investors have shifted over 30 years toward short term financial gains
- With exception of the New Economy Bubble, reinvestment of profits in US capital stock has been low
- US job growth (and tax revenue growth) are dampened if firms fail to reinvest profits in 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

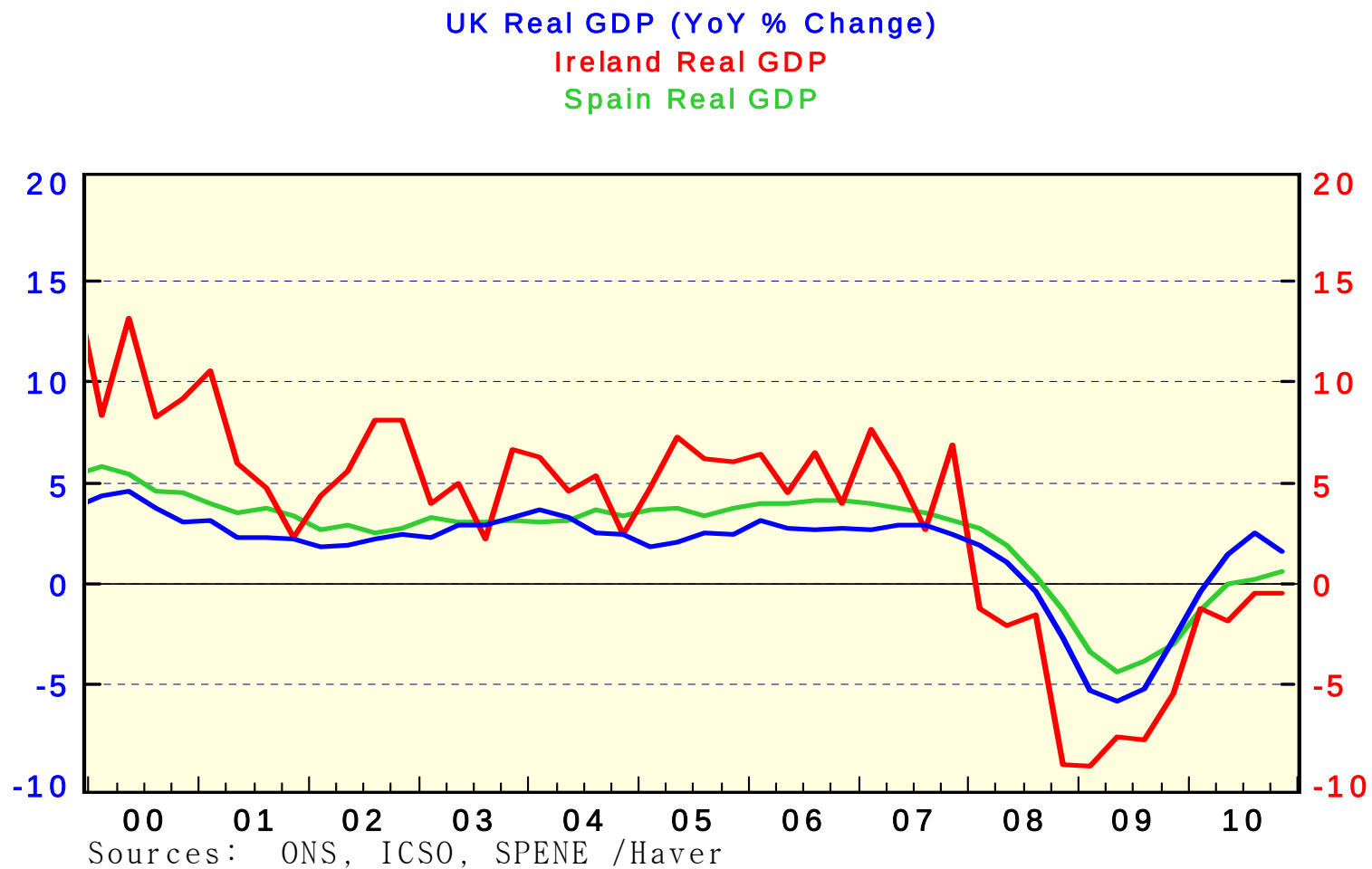
# Fiscal Consolidation...or rediscovering the Paradox of Public Thrift?

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/W DA GDP(SA, %)





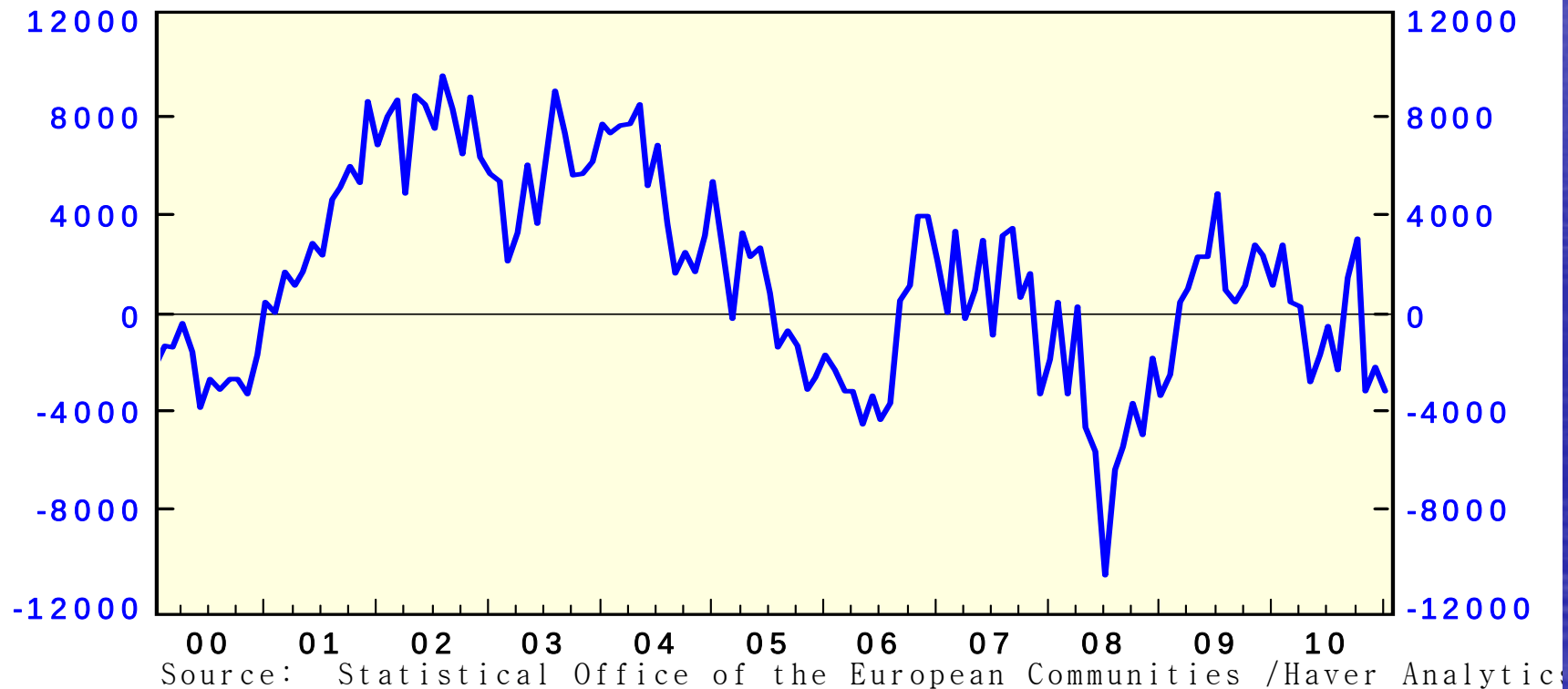
# Expansionary...or Double Dip?



# EU Trade Balances Not Helping

Euro Area16: Trade Balance: Total

SA/WDA, Mil.EUR



# 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