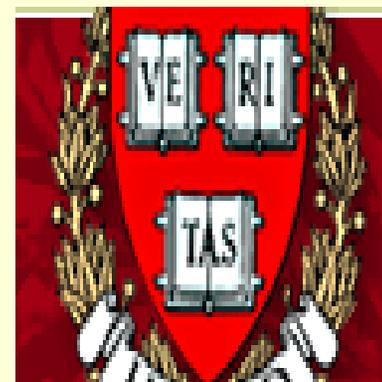


Is the Debt Important?

New England Republican Council
Issues Conference

Boston, April 28, 2007



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Should we worry about debt?

Begin by dividing the question into 3:

- *(I) our private debt,*
- *(II) national government debt,*
- *and (III) international debt.*



(I) Our Private Debt

Household debt -- yes.

Especially among those households who took advantage of mortgage innovations

- e.g., low down-payment, interest-only, teaser rates, & the laxer standards of sub-prime market that has suddenly received so much attention.
- Many people bought houses they could not afford unless prices continued to rise rapidly or real interest rates remained extraordinarily low, which predictably did not happen.



- Also those who took advantage of home equity loans to consume more than they should (in the sense that many are not saving enough for their retirement).
 - Troublesome for some, especially lower-income workers.
- Probably has contributed to slowdown; it may or may not lead to a recession later this year as Alan Greenspan says.



Corporate debt



- We've heard some warnings this week of excessive leverage among some companies.*
- They say that high liquidity has produced a bubble in private equity.
- Overall, corporate debt problem is not that bad.
 - The corporate profit share is at a long-term high.
 - It is true that this is the mirror image of low real interest rates, and flat real wages, both of which are likely to come to an end.

* Bank of England; and Larry Fink, Chief of BlackRock, fund management group.

It is true that spreads on high-income corporate debt are inexplicably low.

- Also the implied volatilities in options prices have been much too low.
- Part of a general pattern: **private markets are underestimating risk**,
 - a result of 5 years of low real interest rates & of formulas that estimate volatility from lagged prices – which look calm – rather than from an intelligent assessment of the macro outlook & the odds of unexpected shocks.
- So there are some vulnerabilities.
 - But corporate balance sheets are not where I see the greatest problems now.

Medium-term global risks

- Bursting bubbles
 - Housing market downturn, underway
 - Bond market crash, not yet
- Possible new oil shocks,
 - e.g., from Russia, Venezuela, Nigeria, Iran...
- Possible new security setbacks
 - Big new terrorist attack, perhaps with WMD
 - Korea or Iran go nuclear/and or to war
 - Islamic radicals take over Pakistan, S.A. or Egypt
- Hard landing of the \$: foreigners pull out =>
\$ ↓ & i ↑ => possible return of stagflation .



(II) National Government Debt

- When Ronald Reagan took office he gave a speech on the evil of the \$1 trillion debt he had inherited
- In his 1st term, he added a 2nd trillion to the debt, more than all 40 previous presidents combined.
- In his 2nd term, a 3rd trillion of debt.
- GHW Bush's term added a 4th trillion.
- In Clinton years, the debt began to fall.
- But George W. Bush is adding as much to the national debt as: his father, Reagan, and the preceding 40 presidents *combined*.



Federal budget in the short run

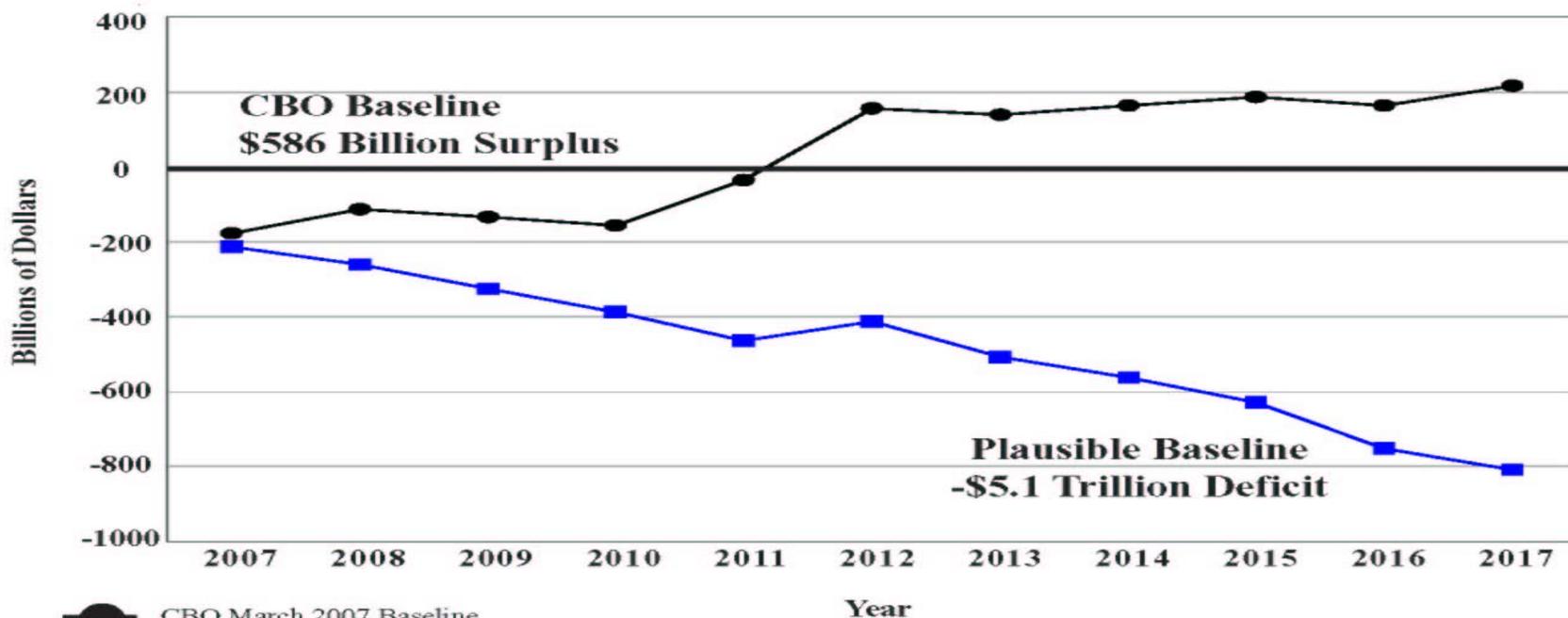
The budget deficit has
come down in 2006-07



- as a result of pretty good growth in national income and tax receipts.
- But this is besides the point.
- The problem is the federal budget in the longer term, and the path on which the current Administration has put us.

Official forecast of budget deficit vanishing by 2012 is fantasy

Concord Coalition Plausible Budget Outlook Fiscal Years 2007-2017



- CBO March 2007 Baseline
- Concord Plausible Baseline assumes that discretionary spending grows at the rate of nominal GDP, that continued operations in Iraq and Afghanistan are gradually scaled back to about a third the current level, and that all expiring tax provisions are extended with AMT relief.

THE CONCORD
COALITION



Ten Reasons Why Bush Budget Forecasts Are Too Optimistic

SPENDING



1. National security spending:

- *Iraq cost still not fully counted in defense budget.*
- Also, they want to build up the military to be able to take on Iran & other countries.
- New weapons systems (won't enhance security).
- Not to mention all the pork that is in the national security budget.

2. Domestic discretionary spending

- Government forecast assumes spending rises only with inflation,
- *but in fact it started rising at $\approx 8\%$ /year when Bush came to office, far higher than under Clinton with caps & PAYGO*
 - e.g., agricultural & energy subsidies
 - prescription drug benefit
 - manned space program...
- Likely to continue [\[1\]](#)

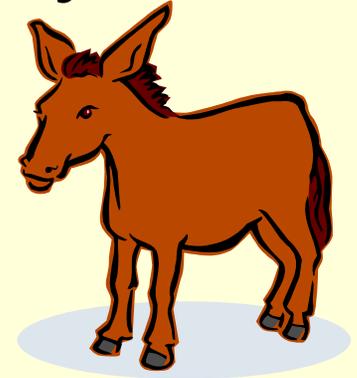


[\[1\]](#) Non-partisan Concord Coalition: if spending were to stay constant as % of GDP, it would add **\$1.1 trillion**. (Or \$1.3 trillion, including interest on the additional debt.)

2 quotes from economic advisors to Reagan & McCain

- Bartlett (2005): “In light of Bush's big-spending ways, Bill Clinton now looks almost like another Calvin Coolidge.”
- Hassett (2005): “spending growth under George W. Bush has been almost four times as high as it was during the same period of Bill Clinton's presidency.”

3. Now that the congressional Democrats are in the majority...



- they may have some priorities of their own to spend money on, like health & education.
- In the 1990s, they were persuaded by President Clinton and the PAYGO rules to hold back, in order to get a budget surplus, having passed the 1993 budget act without a single Republican vote.
- Since Bush blew the surplus, and paid no price for it, it may be more difficult to put together the same Democratic support for budget discipline achieved in the 1990s.

ECONOMIC FORECASTS



4. Some economic & technical assumptions in CBO & OMB forecasts have been overoptimistic,
- e.g., early growth forecast at 3.3% & high labor share of income.
 - Currently, if real interest rates rise to more normal levels, debt service costs will rise sharply.

TAX CUTS

5. White House proposes extending tax cuts passed in 2001 and 2003, and
6. permanently ending estate tax in 2010.
7. Had also proposed privatizing social security and expanding IRAs/401(k)s; all of which would have lost revenue esp. outside the 5-year budget window.
8. Eliminate Alternative Minimum Tax ^[1]

^[1] Estimated cost \$0.7 trillion .

ENTITLEMENTS

9. Social Security ^[1]

10. Medicare

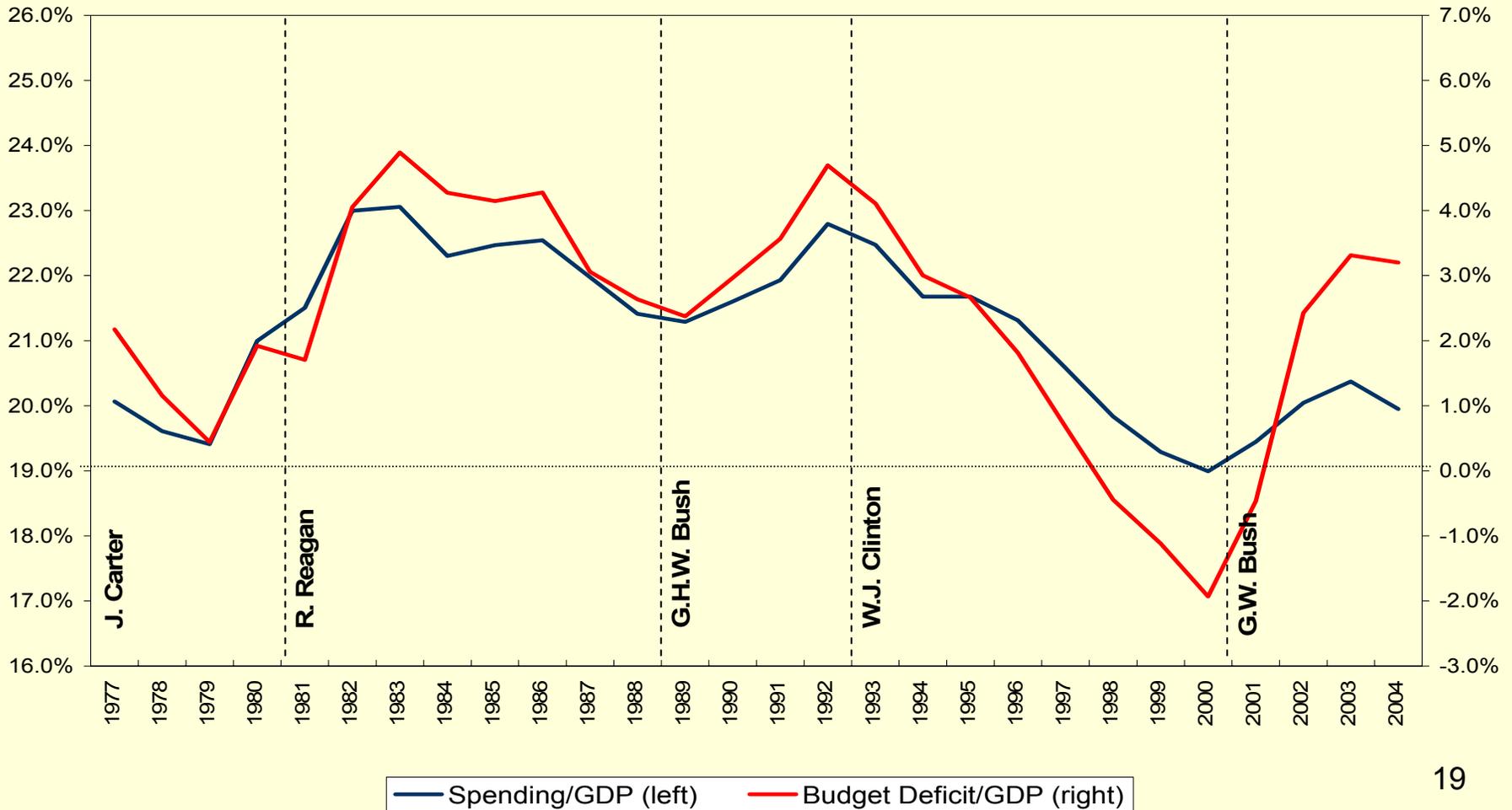


^[1] Official forecasts count **\$2 1/2 trillion** in payroll tax revenues that are in fact supposed to go to Social Security; even that is far from enough to pay for promised benefits.

What about the “Starve the Beast” hypothesis (“tax revenue↓ => spending↓”) ?

- History shows that the Starve the Beast claim does not describe actual spending behavior.
- Spending is only cut under a regime of “shared sacrifice” that simultaneously raises tax revenue (the regime of caps & PAYGO in effect throughout the 1990s)
- Spending is not cut under a tax-cutting regime (1980s & current decade).
- See Figure 2.

Fig. 2: US Federal Budget Deficit and Spending as % of GDP.



Further, even if the Starve the Beast hypothesis *did* describe actual behavior...

- It would contradict the original rationale for the tax cuts: the Lafferite hypothesis that *“tax rate cuts produce more tax revenue.”*
- “Starve the Beast” would then predict more government spending not less.
- Is Laffer a straw man?
 - President George W. Bush, July 24, 2003
 - OMB Director Joshua Bolten, press conference July 2003; & *WSJ*, Dec. 10, 2003
 - Treasury Secy. John Snow, Congr. testimony, Feb. 7, 2006: “Lower tax rates are good for the economy and a growing economy is good for Treasury receipts.”

III) Our International Debt



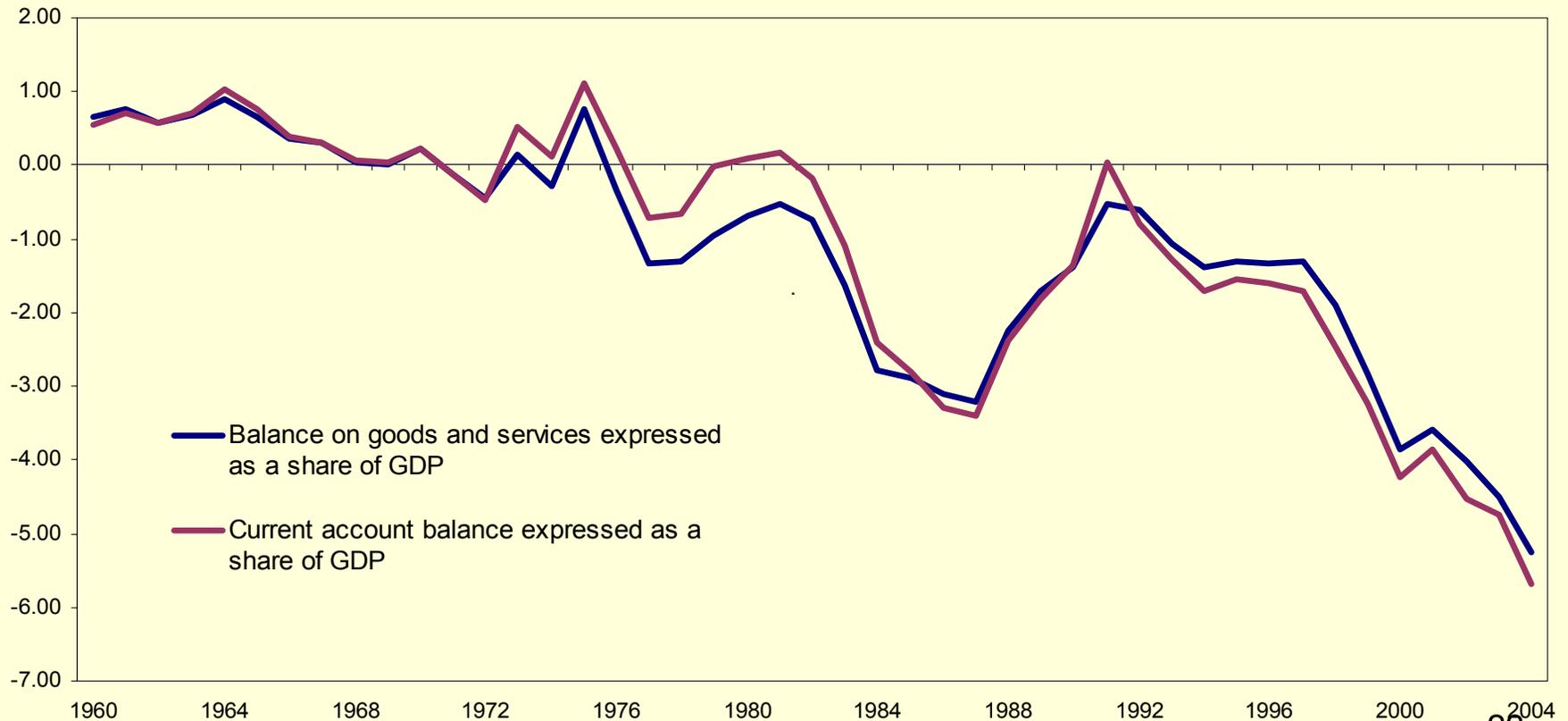
The US Current Account Deficit: Origins and Implications

Revised version of Our Fiscal Future, 2006

Trade balance is deteriorating

U.S. Trade Balance and Current Account Balance, 1960-2004

**% of
GDP**

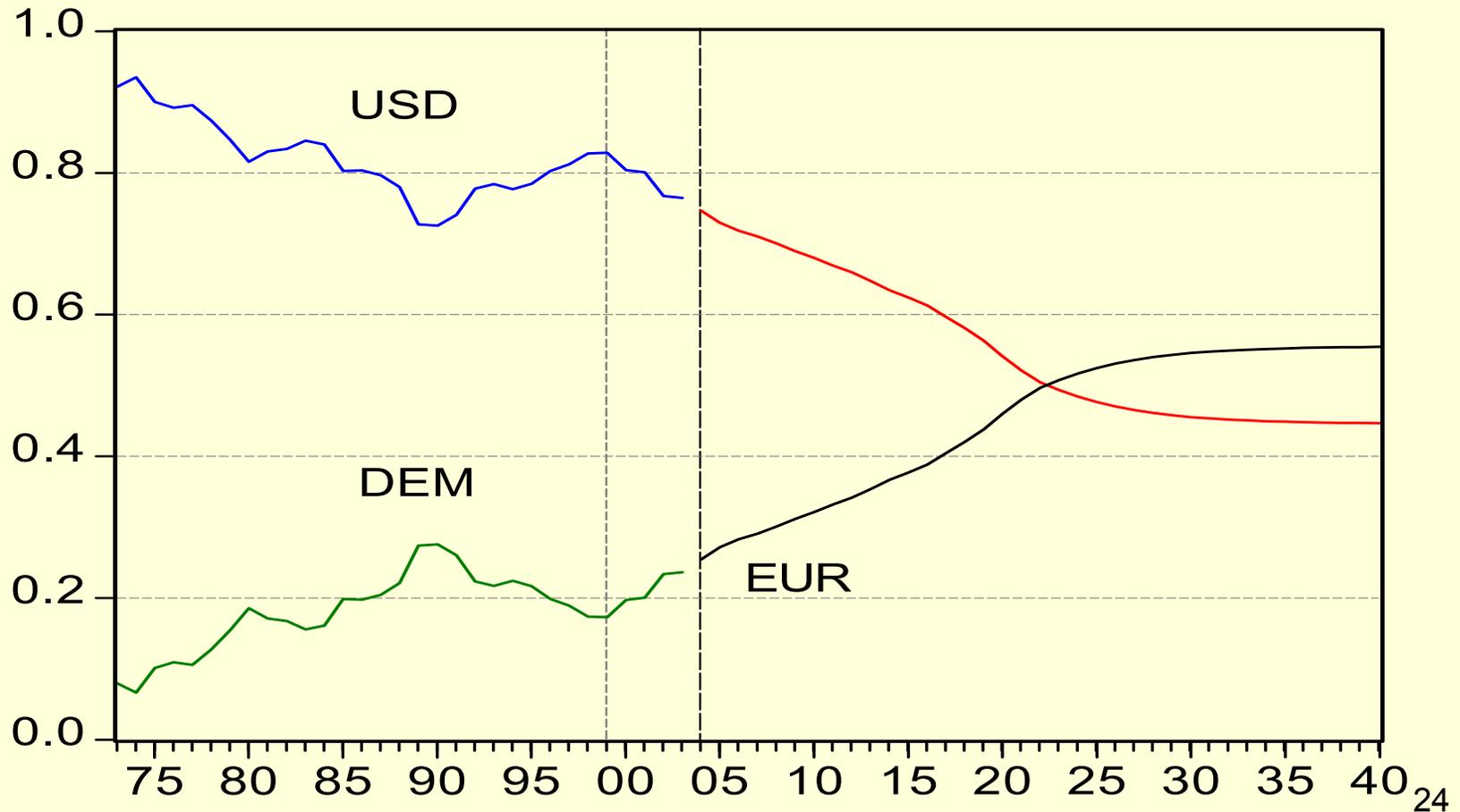


Sources: Department of Commerce (Bureau of Economic Analysis) U.S. Economic Accounts

Trade deficit

- Current account deficit for 2006 \approx 6% GDP, a record.
 - Would set off alarm bells in Argentina or Brazil
- Short-term danger: Protectionist legislation, such as Schumer-Graham bill scapegoating China
- Medium-term danger:
 - CA Deficit \Rightarrow We are borrowing from the rest of the world.
 - Dependence on foreign investors may \Rightarrow hard landing
- Long-term danger:
 - US net debt to RoW now \approx \$3 trillion.
 - Some day our children will have to pay it back \Rightarrow lower living standards.
 - Dependence on foreign central banks
may \Rightarrow loss of US global hegemony

€ could surpass \$ as leading international reserve currency by 2022 – Chinn & Frankel (2007)



Origins of Current Account deficits

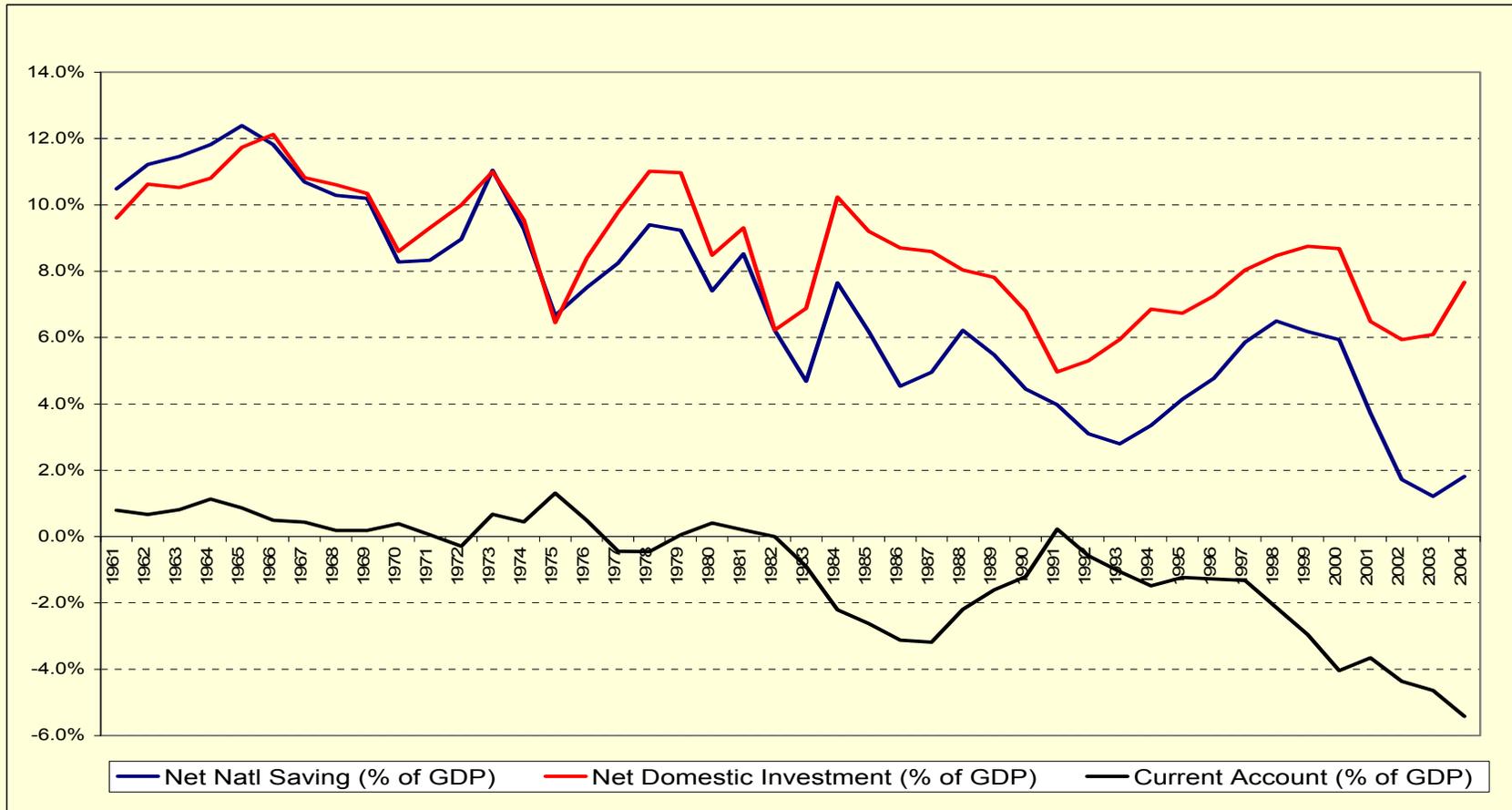
- Trade deficits are not primarily determined by trade policy (e.g., tariffs, NAFTA, WTO, etc.)
- Rather, by macroeconomics.
- Deficits are affected by exchange rates and growth rates.
- But these are just the “intermediating variables”
- More fundamentally, the US trade deficit reflects a shortfall in National Saving

The decline in US National Saving

- National Saving \equiv how much private saving is left over after financing the budget deficit.
- US CA deficit widened rapidly in early 1980s, & more so 2001-06, because of sharp falls in National Saving



National Savings, Investment & Current Account, as shares of GDP

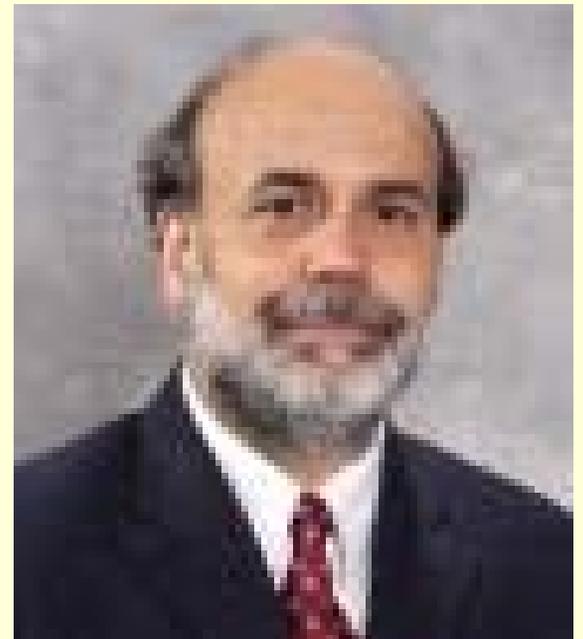
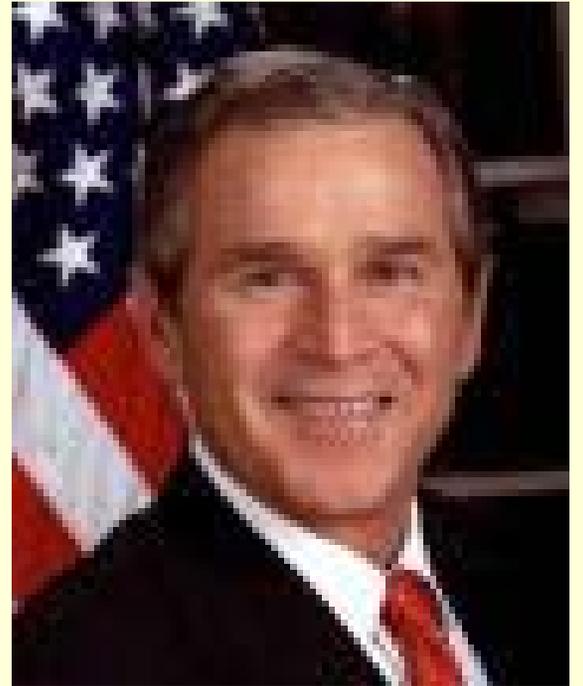


Why did National Saving fall in early 1980s, and 2001-05?

- The federal budget balance fell abruptly both times
 - From deficit = 2% of GDP in 1970s, to 5% in 1983.
 - From surplus = 2% GDP in 2000, to deficits >3% now.
- According to some theories, the pro-capitalist tax cuts were supposed to result in higher household saving.
- Both times, however, saving actually *fell* after the tax cuts.
- U.S. household saving is now < 0 !
- So both components of US National Saving fell.

What gave rise to the record federal budget deficits?

- Bush Administration: Large tax cuts, together with rapid increases in government spending
- Parallels with Reagan & Johnson Administrations:
 - Big rise in defense spending
 - Rise in non-defense spending as well
 - Unwillingness of president to raise taxes to pay for it.
 - Leads to declining trade balance
 - Eventual decline in global role of the \$.
 - They had ignored the advice of their CEA Chairmen.

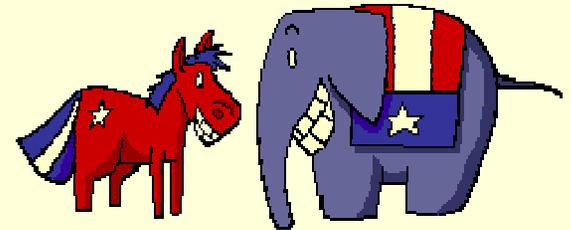


Best precedent for fiscal expansion that began in 2001?

- Reagan's 1980s fiscal expansion is a good precedent; it too came from a president raising defense spending without being willing to pay for it.
 - Weidenbaum quietly resigned over spending.
 - Feldstein popularized "Twin deficits."
- But 1967-72 Vietnam-era expansion fits even better:
 - (1) Monetary policy was accommodating then, as recently.
 - (2) The dollar's international currency standing began a trend decline in the 1970s, which the Iraq-era expansion is now restarting.

A pattern: illiberal economic policies (GOP presidents) vs. intellectually honest and consistent conservative economics (e.g. Cato)

- Republicans are supposed to support small government; but federal employment rose under Presidents Nixon, Reagan and Bush, and shrank under President Clinton.

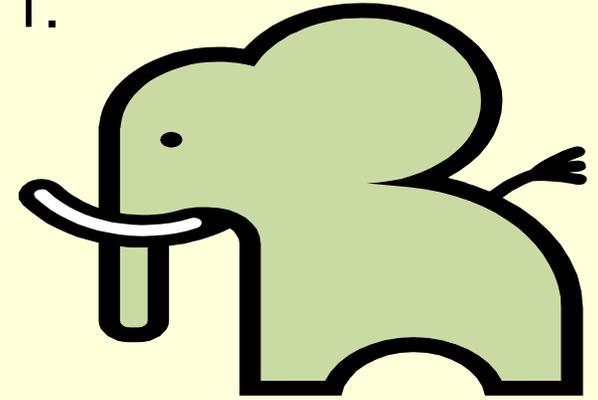


- The trend toward deregulation that most imagine began in the Reagan Administration? It actually began in the Carter Administration – in airlines, trucking, natural gas, and banking.

Niskanen (1994)

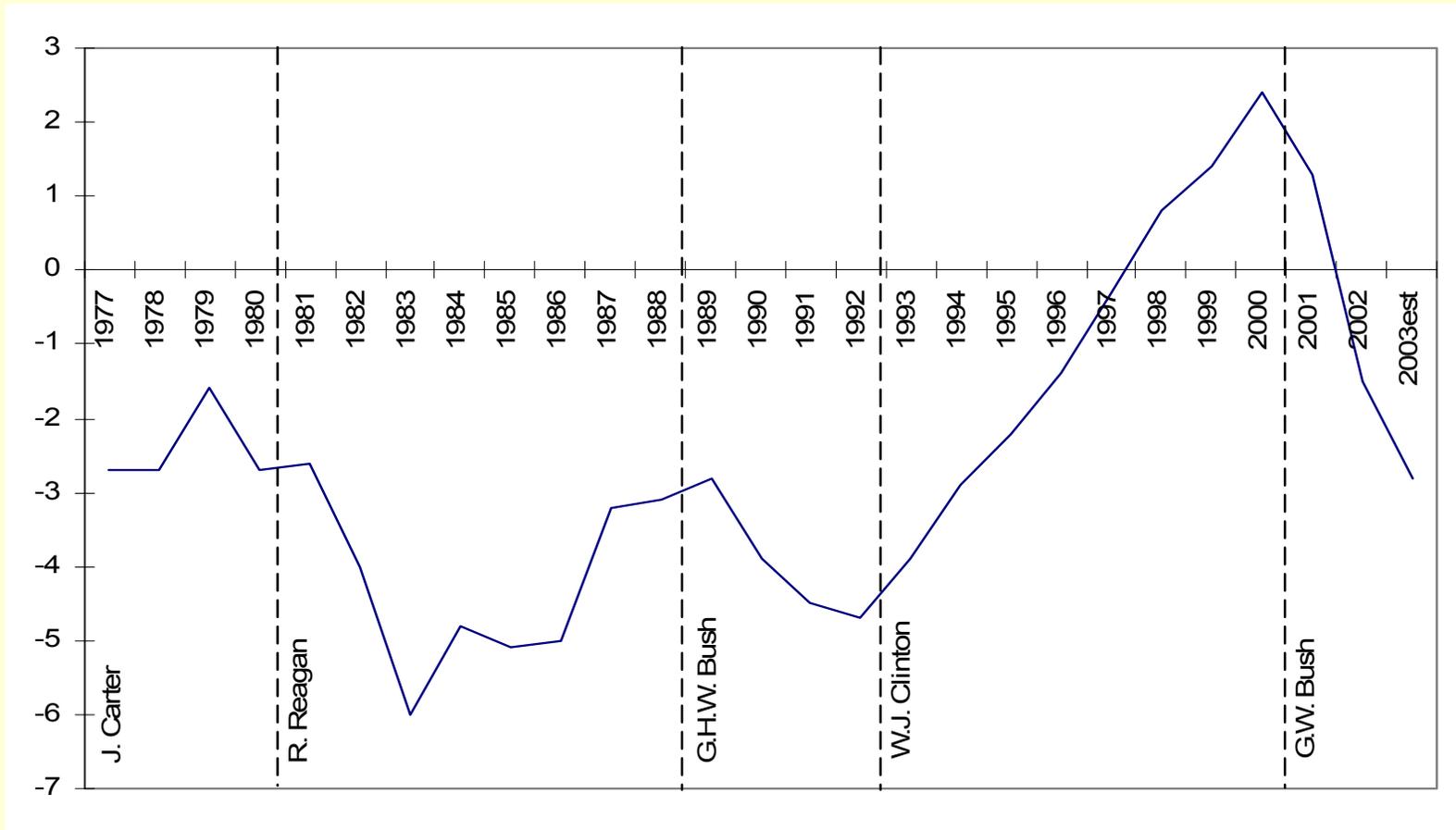
Budget deficits seem to rise when a Republican becomes President

-- the solid line in Fig. 1.



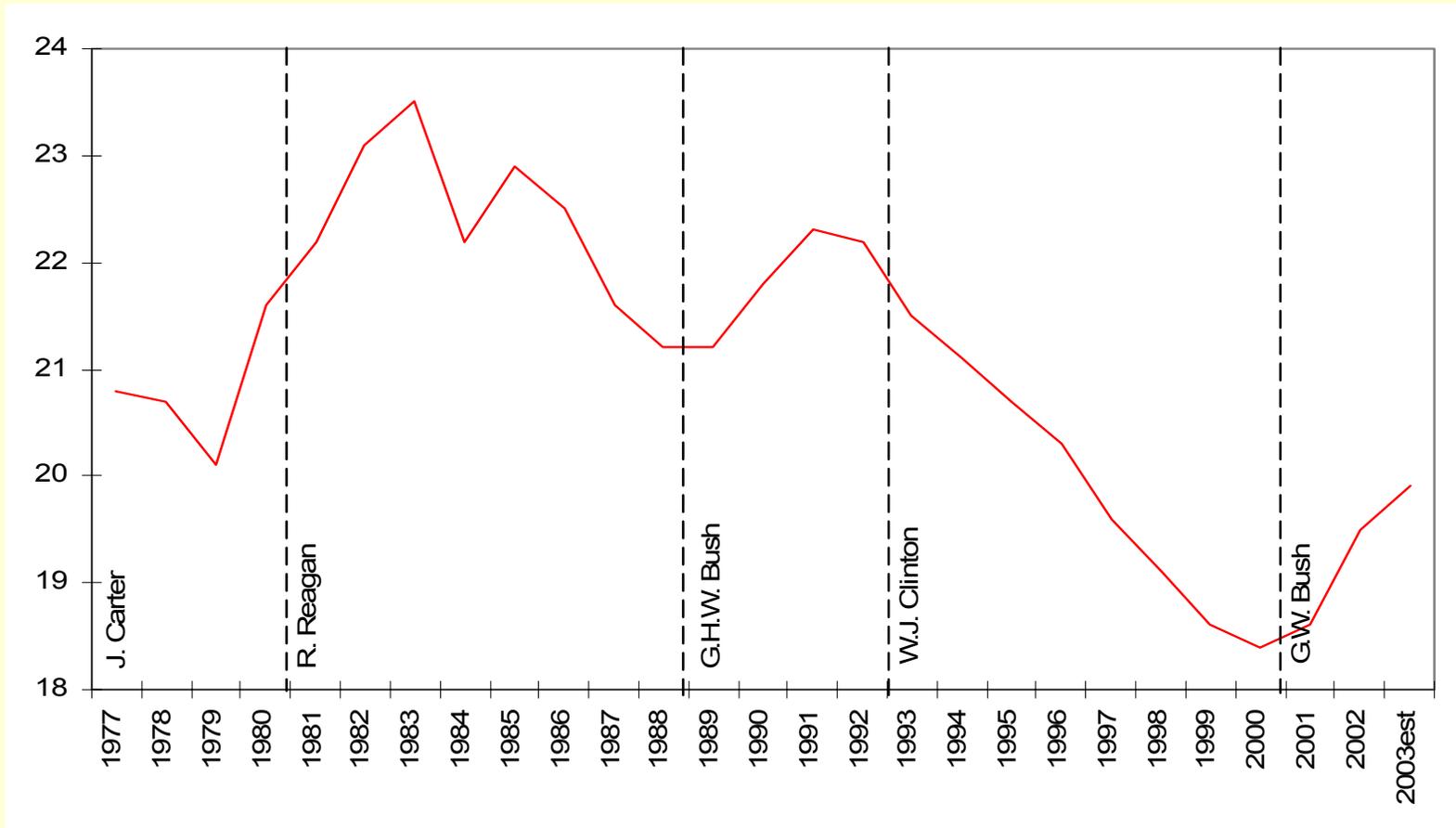
- Just because Republicans cut taxes and Democrats raise them?
- Embarrassingly for the Republican presidents spending tends to go up when they take office (dotted line), much as the budget deficit does.

Fig. 1 Budget balance as % of GDP, 1977-2003



Source: Office of Management and Budget

Fig. 2 Spending as % of GDP, 1977-2003

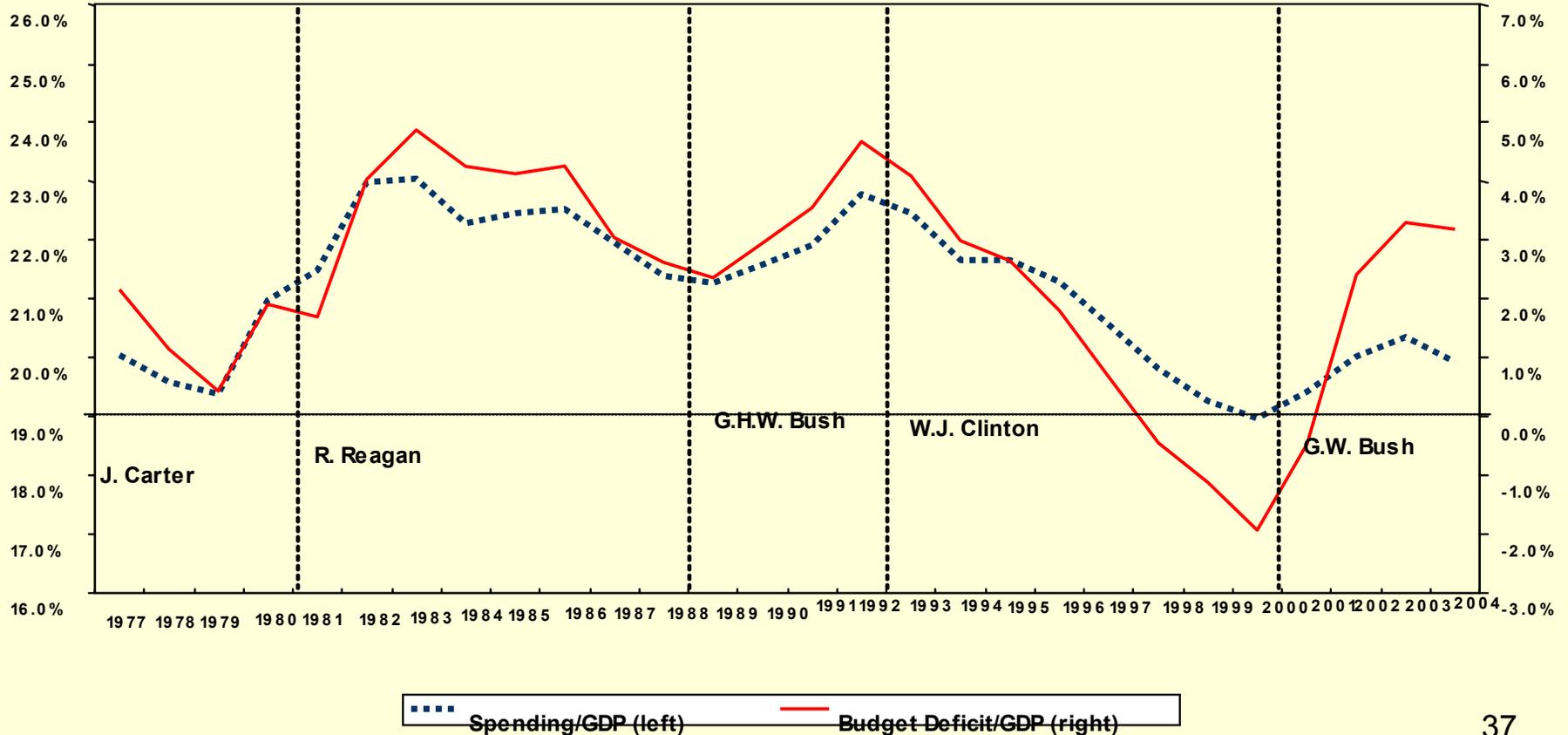


Source: Office of Management and Budget

The “Starve the Beast hypothesis”
($t \downarrow \Rightarrow BD \uparrow \Rightarrow G \downarrow$) is rejected:

- Statistically -- Niskanen (2002).
- Historically – spending growth is only cut as part of a shared sacrifice regime.
- Logically -- if the alternative is the PAYGO approach of the 1990s.

Fig. 1: US federal budget deficit and spending as shares of GDP



Provocative claim: Republican Presidents' economic policies have been the less conservative

In practice, over the last 35 years, Presidents Nixon, Reagan and the Bushes supported

- more inflationary monetary policy,
- more protectionism
- more handouts for special interests (energy, agriculture, airlines...),
- bigger budget deficits,
- bigger government, and
- more moral hazard

than did Presidents Carter and Clinton .



Republican presidents have been protectionist despite free trade rhetoric.

- judged not just by some politics-free ideal, but as compared to the record of Clinton.
- “Nixon shock” imposed a 10% surcharge on imports and embargoed essential foodstuffs to Japan.
- Ronald Reagan
 - e.g., “voluntary” export restraints on autos
 - Niskanen (1994) “...the administration imposed more new restraints on trade than any administration since Herbert Hoover”
- George W. Bush
 - tariffs on steel and lumber; sugar-distorted Australian FTA.
 - Bartlett (2006) now judges that it is George W. Bush who has been the most protectionist since Herbert Hoover.

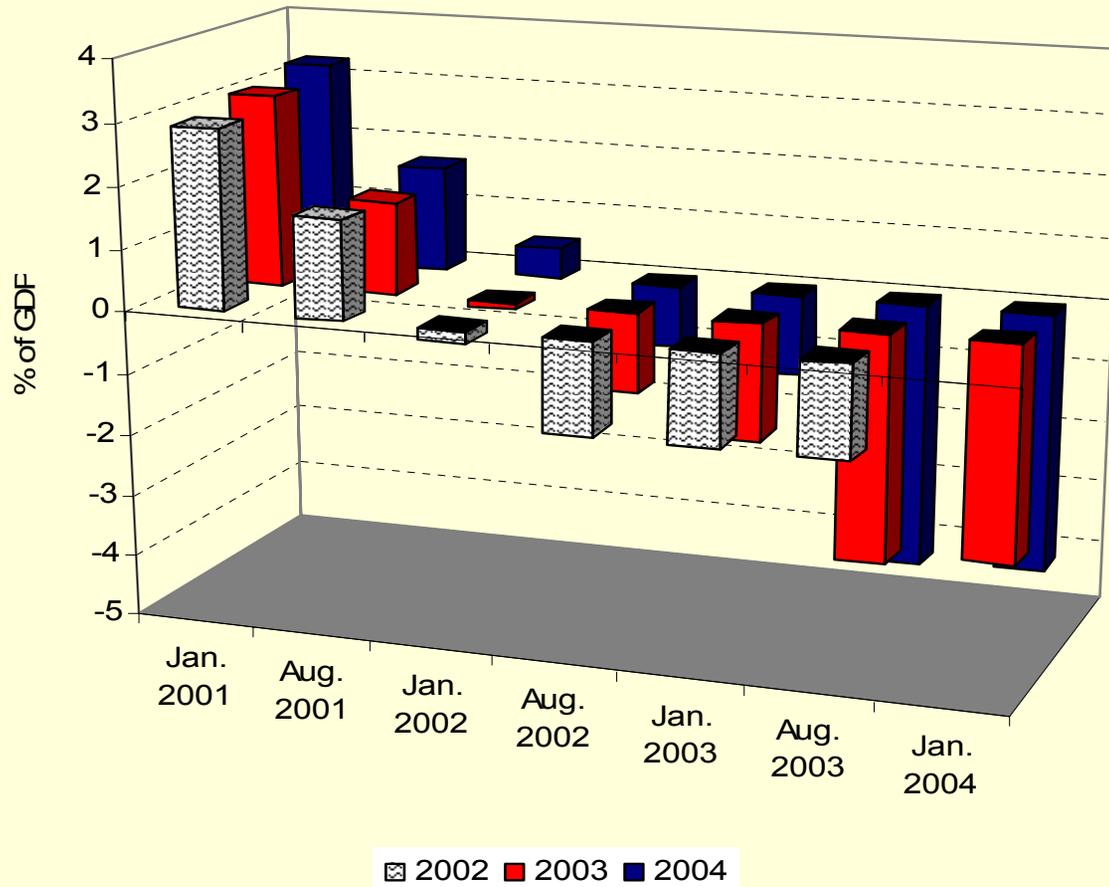
Conclusion

- Rhetoric is not enough. Our leaders need to respond to events in the real world..
- The response has to be well-informed, thoughtful, appropriate to the problem at hand.
- Thoughtfulness does not thrive if smothered by
 - insincere laissez faire rhetoric,
 - political expediency,
 - an absence of free discussion of policy options, or
 - unwillingness to process new information when real-world developments diverge from the script that had been provided by presidential speech-writers.

Appendix 1: The Bush Budget Bungle



Fig. 3 Forecasted Annual Budget Balance as % GDP



Source: Office of Management and Budget

White House forecast of eliminating budget deficit by 2012 will not be met under their policies

- WH and CBO projections still do not allow for
 - The full cost of Iraq and other “national security” spending
 - Fixing the Alternative Minimum Tax
 - Making permanent the tax cuts as it has asked for
 - More realistic forecasts of spending growth, e.g., in line with population. (Actually spending growth since 2001 has far exceeded that.)
- More likely, deficits will not fall at all.
- Just as the budget forecasts were predictably overoptimistic throughout the first Bush term.
 - The surplus of \$5 trillion+ forecasted in Jan. 2001 over 10 years became a 10-year *deficit* of \$5 trillion.

Further, the much more serious deterioration will start after 2009.

- The 10-year window is no longer reported in White House projections
- Cost of tax cuts truly explode in 2010 (if made permanent), as does the cost of fixing the AMT
- Baby boom generation starts to retire 2008
 - => soaring costs of social security and,
 - Especially, Medicare

Appendix 2:

Many economists have come up with ingenious counter-arguments to the twin deficit concerns.

- But I don't buy them.
- I.e., the twin deficits that face us now and in the future should indeed be a source of concern
- Low US national saving is roughly a “sufficient statistic” for the problem.

7 alternate views that purport to challenge the “twin deficits” worry

- The siblings are not twins
- Alleged Investment boom
- Low US private savings
- Global savings glut
- It's a big world
- Valuation effects will pay for it
- China's development strategy entails accumulating unlimited \$

Appendix 2:

Possible loss of US economic hegemony.

- US can no longer necessarily rely on the support of foreign central banks, such as China.
- China may allow appreciation of RMB.
- Even if China keeps RMB undervalued, it can diversify its currency basket out of \$
 - There now exists a credible rival for international reserve currency, the € .
 - Chinn & Frankel (2005): under certain scenarios, the € could pass the \$ as leading international currency.
 - US would lose, not just seignorage, but the exorbitant privilege of playing “banker to the world “

Possible loss of US political hegemony.

- In the 1960s, foreign authorities supported \$ in part on geopolitical grounds.
- Germany & Japan offset the expenses of stationing U.S. troops on bases there, so as to save the US from balance of payments deficit.
- In 1991, Saudi Arabia, Kuwait, and others paid for the financial cost of the war against Iraq.
- Repeatedly the Bank of Japan bought \$ to prevent it from depreciating (e.g., late 80s)
- Next time will foreign governments be as willing to bail out the U.S.?

Historical precedent: £ (1914-1956)

- With a lag after US-UK reversal of ec. size & net debt, \$ passed £ as #1 international currency.
- “Imperial over-reach:” the British Empire’s widening budget deficits and overly ambitious military adventures in the Muslim world.
- Suez crisis of 1956 is often recalled as occasion when US forced UK to abandon its remaining pretensions to an independent foreign policy;
- Important role played by simultaneous run on £.