

WHAT A LONG, STRANGE TRIP IT'S BEEN: CAN WE MUDDLE THROUGH WITHOUT FISCAL POLICY?

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When the Fed began to tighten in order to fly the economy to a soft-landing, most pundits were sure that Greenspan would be able to contain any downturn by appropriately softening the monetary policy stance. And when the economy did indeed tumble toward recession, the first instinct was to turn to the Fed, which predictably loosened policy in a dozen steps. When that appeared to have no effect, President Bush and the republicans called for tax cuts and additional fiscal stimulus. The rich got a long term tax cut, while most Americans had to settle for a small and temporary rebate, after which the democrats succeeded in forestalling any agreement for a broader stimulus package. By spring of 2002, the push for fiscal stimulus had all but disappeared as the conventional wisdom held that recovery was underway, or at least on the horizon. The Fed's adept loosening had done its job, the landing would be soft, and consumers would resume their spending spree to restore our Goldilocks economy.

This instinctive turn toward monetary policy for stabilization represents the culmination of a long-term trend away from "Keynesian" reliance on fiscal policy. It has become virtually common wisdom that government should strive to maintain a structural budget surplus. The primary justification for this is that government budget surpluses add to national saving—which has become increasingly important given the aging of Western populations in conjunction with postwar expansion of promised retirement benefits, especially those associated with public pensions (Social Security). Even if it is recognized (sometimes, but not always) that such surpluses drain income and outside wealth from the economy, most economists and policy makers are convinced that monetary policy can compensate. Hence, it is widely believed that the Fed will, or already has, guided the US economy back to recovery—with only minimal fiscal stimulus. On current projections, fiscal surpluses will reappear within two or three years.

Even as of fall 2002, there are many reasons to doubt this happy scenario. In this paper, we will examine the case for "muddling through" without fiscal stimulus. It is said that the Fed's low interest rate policy has reduced debt service burdens and will thereby encourage consumers to spend the resulting after-debt-service income, and as well to begin to deficit spend anew. As

evidence, much is made of continued growth in the housing sector. However, we argue that there are several problems. First, historically, lower fed funds rates have normally had little impact on debt service burdens. We will show that debt service burden is actually driven by debt to income ratios, not by interest rates. Second, if growth is to be fueled by the private sector, its debt must continue to grow—especially in the context of a trade deficit. If low but positive economic growth were to resume (“muddling through”), debt-to-income ratios would have to grow well beyond current, record, levels. We will include a Minskian-type analysis that argues that private-sector-led growth is necessarily highly unsustainable given current US realities. Hence, it is difficult to see where the domestic demand will be coming from, given the existing fiscal stance. Furthermore, we will show that policy in the rest of the world has more-or-less followed the US model such that public sector budgets are very much tighter in much of the world. And just as in the US, this means that private sector balances have deteriorated, subjecting these economies to greater potential instability, and to longer term slow growth. This means the US cannot look to the rest of the world for demand, hence, the US balance of payments is not likely to improve.

More fundamentally, we will argue that the notion that government “saving” (that is, budget surpluses) can add to “national saving” and thereby provide for future retirees is flawed. The wide-spread idea that Social Security ought to run surpluses (with the rest of the budget in balance) in order to build a Trust Fund out of which retirement benefits can be paid later misunderstands the nature of government spending and results in a budget that prevents full employment growth. If anything, this hinders society’s ability to provide for future retirees. Indeed, in the specific case of the US today, not only is a cyclical deficit required so that we might “muddle through” our recession, but a long-term budget stance biased toward structural deficits at full employment is required.

A BRIEF HISTORICAL PERSPECTIVE

In a revealing and in some sense prescient piece, Herb Stein (Chairman of the Council of Economic Advisers under Presidents Nixon and Ford) reflected in 1988 on the evolution of postwar thinking about the government budget. At the end of WWII, most economists accepted the notion that the budget should achieve balance only at full employment and robust economic growth. If there is any doubt about this, one need only examine Milton

Friedman's 1948 article, "A Monetary and Fiscal Framework for Economic Stability". (Friedman 1948) In that piece, he put forward a proposal according to which the government would run a balanced budget only at full employment, with deficits in recession and surpluses in economic booms. All government budget deficits would be financed through money creation. Surpluses would destroy money. He thus proposed to combine monetary policy and fiscal policy (as they are usually defined), using the budget to control monetary emission in a countercyclical manner.

In the US a problem arose, however: which budget should be balanced at full employment? As Stein argues, the Social Security system was established in 1935 with its receipts and expenditures placed outside the budget "on the theory that the receipts did not belong to the government but were held in trust for future beneficiaries". Thus, the question was whether to include Social Security's surplus in calculating the overall budget stance. The Committee for Economic Development tackled this issue in its 1947 proposal "Taxes and the Budget: a program for prosperity in a free economy" (drafted by Stein). It concluded that the surplus in the Social Security program should be counted, hence, at full employment the rest of the budget should run a deficit equal to Social Security's surplus. Indeed, the report attributed the sharp downturn of 1937-8 to the emergence of the Social Security surplus at that time. It was recognized that "the economy will not be able to operate at full employment if the government runs a large surplus, because the government will be extracting much more from the private-income stream in taxes than it is putting back in expenditures". (Stein) This would be acceptable only above full employment; below full employment, an overall budget deficit would be in order.

Over the course of the 1960s, this belief held sway. The Kennedy tax cut was justified on the basis that it would be "consistent with balancing the consolidated budget at high employment". (ibid) President Johnson's budgets were similarly guided by the principle that "the consolidated or, as it is now called, the unified budget, be the basic concept". It is also interesting to note that (despite the commonly held belief that Democrats are "big deficit spenders" and despite the fact that the USA simultaneously pursued a war on three fronts—Cold War, Viet Nam War, and the War on Poverty) all through the 1960s the deficit never exceeded more than 1% of GDP. One could argue that even in the 1960s the budget may have been too tight because with more than 3.5 million men in the armed forces we still were not able to attain full employment on any of the pre-Friedmanian-of-1968

definitions. In any case, the principle was accepted even if not strictly followed that the budget should swing sufficiently toward deficit to achieve full employment.

Over the course of the 1970s, however, economic thinking changed as Monetarism gained force. Stein explains: “As money came to play a larger role in thinking about the overall performance of the economy, it became clear that there was no unique size of consolidated surplus or deficit that was necessary for, or consistent with, high employment. Sharp year-to-year changes in the size of the surplus might be disturbing, but the economy could achieve high employment with a stable surplus or deficit of any size, if it was accompanied by a suitable monetary policy.” Stein reports that this recognition “liberated” him from the ideas he had promoted in 1947. As head of Nixon’s Council of Economic Advisors, he tried to push the idea that the overall budget should run a surplus at full employment equal to the surplus in the Social Security program. This would allow for “more national saving, more national investment and higher future national income out of which to support the growing number of retired people”. Stein found, however, that he was ahead of his time—the “Bureau of the Budget insisted such a surplus would be an intolerable burden on the economy, and the director could not be induced to sign on to our recommendation”.

By 1983, Washington had caught up to Stein’s way of thinking—ironically, after a deep recession and exploding budget deficits. A commission was formed with Alan Greenspan at its head to “reform” Social Security. For our purposes, two major changes were made. First, Social Security surpluses were to be placed “off-budget” and ignored in thinking about the size of the budget deficit. Given that Social Security was running surpluses, this meant the budget deficit (ex-Social Security) would be reported as larger. Second, Social Security was “reformed” with large payroll tax increases as well as benefit cuts so that its surpluses would rise. In this way, a huge Trust Fund would be accumulated as “national savings” to take care of tomorrow’s retirees.

The large Reagan-Bush budget deficits (with or without Social Security’s surpluses) led to a series of attempts to reign-in spending. The Gramm-Rudman-Hollings Act of 1985 mandated movement toward a balanced unified budget (including Social Security’s surpluses). Stein predicted in 1988 that this would lead to budget balance within five to seven years. As we now know, that may have been a bit optimistic—a deep recession at the

end of the 1980s followed on the heels of the historic budget agreement, throwing the federal budget deeply into deficit. However, further budget tightening agreements under President Clinton succeeded in generating a budget that would run surpluses at moderate growth rates, such that a surplus was indeed achieved (with the help of Goldilocks) within Stein's projected time frame. By 2000, the overall federal budget surplus reached almost \$300 billion and projections showed surpluses as far as the eye could see. The surpluses achieved were so large they absorbed almost all the maturing Treasury debt; many analysts even predicted that all outstanding debt would be retired by the middle of the second decade of the new millennium. Even the Fed held conferences exploring the consequent impacts on financial markets and the conduct of monetary policy in the absence of government debt.

As Stein argued, the evolving perspective on monetary policy was key to the new view on the role of fiscal policy. No longer was the budget to be used to stabilize demand; rather, permanent surpluses should be run to "increase national savings", all the more important given the "burden" that retiring baby-boomers would place on future workers. Monetary policy would step up to the plate to play the stabilizing role. When the economy was believed to be in danger of "overheating", Greenspan's Fed would raise interest rates to cool it—for example, in 199x the Fed raised rates a dozen times to fight incipient inflation. If demand should falter, the Fed would come to the rescue with lower interest rates. Interestingly, the Monetarist experiment at controlling monetary aggregates in the early to mid 1980s was widely perceived to be a complete failure, however, confidence in the Fed's ability to fine-tune the economy through quite small changes to overnight rates (typically, the Fed would change rates by 25 to 50 basis points each time) only grew over the course of the 1980s and 90s.

When Goldilocks collapsed, purportedly in the face of the bursting of the IT bubble as well as the 9-11 attacks, all eyes turned to the Fed. It is true that President Bush altered the justification for his proposed tax cuts from Supply Side to Demand Stimulus arguments, and it is true that the spending increases necessary to rebuild NYC, to upgrade national security, and to fight the world-wide war on terrorism all raised demand. However, most of the credit for the apparent recovery from the official recession was given to Chairman Greenspan's Fed. To be sure, there is still some talk of further economic stimulus to come from fiscal policy, but there is little reason to doubt that most responsibility for guiding the economy through its recovery

will be left to the Fed. In a sign of the times, the Democrats have become the party of fiscal responsibility, arguing against expansion of the role to be played by fiscal policy and berating the Republicans for the tax cuts that are said to be damaging our nation's long-term health by lowering national savings.

Significantly, the debate about Social Security re-emerged during the Clinton boom even as the rest of the budget moved for the first time to surplus. We don't need to get into all the details as to why popular concern about the long-term financial viability of Social Security arose at this particular time. What is important is that President Clinton and then-Candidate Gore decided to "protect" Social Security by "devoting" a portion of actual and projected budget surpluses to the program. This would be "added to" Social Security's surpluses and put into "lock boxes" out of the reach of greedy politicians, to be used in future decades to care for retirees. This provided an opportunity for the opponents of Social Security to advance various alternative proposals to privatize, or partially privatize, the program by "investing" the Trust Fund in equities and other private assets. In some sense, it could be argued that this would return the program to the original 1930s vision that the program's "receipts and expenditures did not belong to the government but were held in trust for future beneficiaries". In truth, that had never been the case—and, indeed, could not be the case for a federally-funded program. The Clinton-Gore proposal, adopted by the Democrats, never made any economic/accounting sense and it proved to be a political blunder. In any case, the disappearance of the budget surpluses put the Democrats in the (for them) unusual position of defending budget austerity as a way to "protect" Social Security, even as it provided an opening for the program's opponents. Only the bursting of the Nasdaq bubble and the Enron fiasco (in which employee pensions disappeared) obstructed the privatizers.

It is interesting that Chairman Greenspan even tried to move the goal posts early this fall: not only should the overall budget be tightened to eliminate deficits, but Social Security's projected future deficits should be included in today's calculation of the budget balance! In testimony before the US House Committee on the Budget (September 12, 2002), the Chairman exhorted Congress to renew its commitment to "fiscal responsibility" by "restoring fiscal discipline". He bemoaned the federal budget's return to "chronic deficits", now projected to last through at least 2005. More ominously, he warned that "growing contingent liabilities" in the form of future Social

Security and Medicare benefits promised to today's workers represent a "daunting long-term fiscal challenge". He recommended that those future benefits be included as an expenditure in reckoning current budgets—although he seemed to admit that he did not quite know how to do that. Given that these contingent liabilities "amount to many trillions of dollars", not only are long-term reforms of these programs required, but a "disciplined approach to fiscal policy" must be renewed today. If not, chronic deficits will return, absorbing the nation's savings, pushing interest rates up, lowering private investment in capital, and thereby diminishing our future ability to take care of retiring baby-boomers. All this seems to imply that today's budget needs to be very much tighter in order to account for the future liabilities; even a surplus in terms of the unified budget would not be sufficient because Social Security's reported surplus actually would be a huge deficit if contingent liabilities were counted.

Finally, it should be noted that a similar evolution of policy occurred throughout the world, and especially in the developed nations of Europe and Japan. We don't have the time to examine this development closely, but can provide a quick summary—below we will provide some data. In the international sphere, the US pushed privatization, globalization, and free trade as the Washington Consensus reduced government's role in providing protection for workers, consumers, and the environment. But more importantly, the notion that sound fiscal policy means balancing government budgets was spread around the world. International institutions like the IMF and World Bank encouraged fiscal austerity as the solution to any financial crises. Euroland adopted the Maastricht criteria, cutting spending and increasing taxes to reduce government deficits. With the adoption of the Euro, the nations of Europe surrendered fiscal sovereignty and essentially became like American states, no longer able to run sustained budget deficits when needed. Many nations, like Argentina, went further and dollarized or adopted currency boards that impose even tighter constraints on fiscal policy. What all this means is that government budgets became very much tighter at both levels—national, and international. And governments became much less able to deal with recessions when they occur due to voluntarily adopted constraints (Maastricht; currency boards) or involuntary constraints (IMF-imposed).

A QUICK SURVEY OF BUDGET BALANCES

Let's take a quick look at what happened over the past 30 years, but paying most attention to the course of the 1990s US expansion—which is the first expansion in the postwar period in which the federal government did not play a positive role. It is easy to show that the Goldilocks economy was driven by unsustainable private sector deficit spending. Figure 1 shows the income/spending balances for the three sectors of the economy: the private sector (households and firms), the public sector (aggregating across all levels of government) and the foreign sector. Note the sign is reversed for the government sector—a deficit is given a positive sign because it adds to aggregate demand. Note also that in the US state governments almost always run budget surpluses (states are prohibited by constitution, statute, and markets from running deficits). By identity, the private sector's balance equals the sum of the government sector's balance and the foreign sector balance. When the government runs a surplus in the presence of a balance of payments deficit, the private sector must have a deficit.

*Insert Figure 1: the three financial balances

Two things stand out in the figure. First is the huge private sector deficits in the Goldilocks expansion, during which the private sector deficit reached historic levels early in the expansion and then continued to deteriorate to entirely unprecedented levels (well above 6% of GDP by the end of 2000). Also note that in the past, private sector deficits were very rare and never lasted more than about a year and a half. Of course, private deficits mean private debt was also growing. While it is true that the private sector debt-to-disposable income ratio has been growing along a long-term path, the growth of indebtedness accelerated during Goldilocks, with the ratio reaching a peak of twice disposable income by the end of the expansion.

Almost no one at the time, or since, understood that government surpluses imply private deficits. Indeed, on June 29, 1999 the WSJ ran two long articles, one boasting that government surpluses would wipe out the national debt by 2015, while adding to national saving—and the other scratching its head wondering why private saving had gone negative (the heading to a graph showing both trends was “As the government saves, the people spend”—but at no point during the articles was the necessary connection recognized). Indeed, as we have seen above, economists have all along argued that a government surplus would add to national saving, not substitute for private saving. In fact, by simple identity it is not possible to have positive private sector saving in the presence of a budget surplus and a

balance of payments deficit. This simple algebra remains beyond the ability of all but a handful of economists. In other words, when an economist like Stein argues for structural budget surpluses with monetary policy “filling the demand gap”, he is implicitly arguing for structural private sector deficits and growing private indebtedness—although he does not seem to recognize this simple arithmetic.

In sum, the Goldilocks expansion was driven by private sector borrowing—households and firms were going into debt to finance their spending. A private sector deficit increases the outstanding private sector debt stock; the debt ratio increases when debt grows faster than income. In turn, the debt service ratio is a function of debt ratios and the interest rate paid on debt. As Figure 2 shows, the debt service ratio (note that this is only a partial measure that includes mortgage and consumer debt, ignoring business debt service as well as car lease payments that have been growing quickly) typically peaks just above 14% of disposable income. At that point, households usually cut back on borrowing, the economy slows, and frequently the Fed lowers interest rates. However, as the figure shows, it is growth of the debt ratio, not rising interest rates, that drives the debt service ratio. This calls into question the belief that the Fed is able to fine-tune the economy—a topic to which we’ll return.

Insert Fig 2: Debt service and Fed funds

Turning to the international sphere, it should be noted that US Goldilocks growth was not unique in its character. Indeed, Figure 3 shows that the UK experienced almost an identical private sector deficit at the end of the 1980s as the public sector turned to surplus. A long and deep recession followed as the private sector cut back spending in order to run huge surpluses (slowing the economy sufficiently to drive the budget to large deficits). The UK then enjoyed its own version of Goldilocks growth, as the budget again turned toward surplus and the private sector again ran a deficit, albeit smaller than that experienced previously, and smaller than that achieved in the US during Goldilocks.

Insert Fig 3: UK Three financial balances

As the following figure shows, public sector balances in most of the OECD nations also tightened considerably in the past decade—at least in part due to

attempts to tighten budgets in line with the Washington Consensus (and for Euroland, in line with the dictates of Maastricht criteria).

Insert Fig 4: OECD Public sector balances

Tighter public balances, in turn, implied deterioration of private sector balances, as shown in Figure 5. Note that only nations that could achieve significant balance of payments surpluses (such as Ireland) would be able to avoid deterioration of private sector balances in the face of fiscal austerity. In other words, if the public sector does not run a deficit then the private sector cannot run a surplus—that is, save—unless the nation runs a trade surplus.

Insert Fig 5: OECD Private balances

The current Euroland strategy is a modern mercantilist policy—the private sector's net wealth increases mostly by running a trade surplus that generates net wealth in the form of claims on foreign currency. Of course, that is predominately in the form of US dollar claims, and to a lesser extent, UK pound claims. The problem is that this then ties Euroland (and most of Asia) to the economic performance of net importers like the US. (Relying on Latin American net importers is highly problematic because of their frequent bouts of financial and currency instability.) The next figure demonstrates a remarkable degree of synchronicity of real GDP growth among OECD nations, which has been increasing particularly since the breakdown of Bretton Woods, and which emphasizes the dangers inherent in modern mercantilism.

Insert Fig 6: Synchronicity

Two factors have probably contributed toward increased synchronization: first, with the movement to flexible exchange rates each nation fears that relatively robust GDP growth will depreciate exchange rates, hence, economic policy is biased toward keeping growth rates close to those of the other OECD nations. This is probably enhanced by prevailing fads--the pro-market and anti-government biases of the past decade must have influenced the policy stance. Budgets have been tightened such that even low economic growth causes the government budget to move toward balance or surplus. This is why Euroland suffered through high and often rising unemployment

even as the government budget “improved” (significantly, in the US and UK, fiscal surpluses are generated as employment rises, indicating that structural Euro budgets are probably even tighter than those in the US or UK). This means that growth comes mostly from exports or from the private sector. Of course, export-led growth is not possible for everyone simultaneously—for every trade surplus there has to be a trade deficit. And expansion led by the domestic private sector means deteriorating private sector balance sheets. Add on top of that the trend toward dollarization and currency boards and you have a world economy that is biased toward fiscal austerity and slow growth.

Second, increased economic linkages following from "globalization" have probably increased the degree of integration. Particularly when a large net importer--like the US--grows slowly, this is likely to depress growth of other nations. In any case, if recent history is any guide, a sharp and deep downturn in the US will almost certainly spread around the world. The slowdown of growth in the US has already spread to other countries, like Mexico, South Korea, and much of Europe.

It is ironic that Germany of all places will not be able to meet the budget deficit targets that it forced on Euroland. Neither will France or Portugal; perhaps Italy will miss the targets, also. This has led to much hand wringing, calls for further “structural adjustments” combined with fiscal austerity, and even some pointed rejection of Maastricht dictates (for example, by France). Prodi recently (and rightly) called the Maastricht criteria stupid. Still the EU insists budgets must be balanced by 2006, no matter what.

Interestingly, a large part of the argument for European integration was the belief that this would lower interest rates. This followed from two suppositions. First, the required fiscal restraint to enter the union would reduce government borrowing and hence reduce the strain on domestic savings, allowing interest rates to fall. Second, the single currency would lead to uniformly low borrowing rates across the EU—preferably with convergence toward Germany’s relatively low rates—by eliminating currency risk. As we have seen, the first argument is based on the flawed notion that fiscal surpluses can increase national savings. And as we are discovering, the second was wrong as well.

In reality, any sovereign nation with a floating currency can have any government “borrowing” rate it wants, regardless of the size of its deficit.

Indeed, it is the monetary union (or any type of currency board or fixed exchange rate regime) that eliminates the ability to exogenously administer overnight interest rates. Further, as Euroland has discovered, monetary union has not generated the degree of convergence expected. While most analysts do not understand this, it is no more likely that Euro “states” would borrow at the same uniform rates than that US states would face the same borrowing rates. Indeed, the analogy here is quite appropriate: by surrendering fiscal sovereignty, the Euro states have become like American states, forced to borrow “on the market”. Financial markets probably do not yet fully understand this. Even the best of the Euro states in terms of debt-to-GDP ratios or debt-to-tax revenue ratios lags behind the worst US states (such as Louisiana). As Euroland budget deficits grow and as the ability to service debt is called into question, ratings agencies will start to downgrade the government debt. The spread between interest rates enjoyed by “fiscally responsible” nations like Finland and higher rates suffered by fiscally irresponsible Germany and France will grow. Eventually, it will be the market, and not the Maastricht criteria, that dictates maximum deficit ratios. No American state is permitted to run current account deficits equal to 3% of state GDP without substantial downgrading of its debt. To the extent that Euro states can run higher deficits than this, it is because markets have not yet recognized they have surrendered sovereignty. Euroland could be reformulated along the lines of the US—with fiscal union and creation of a centralized Treasury (far more important than monetary union, and would allow servicing of Euro debt). Alternatively states could simply leave the monetary union and return to individual currencies (effectively defaulting on Euro debt; hence, if markets come to expect this, interest rates will diverge along the lines of expected default risk).

CAN WE MUDDLE THROUGH WITHOUT SIGNIFICANT FISCAL STIMULUS?

Not likely. Let us count the reasons.

1. As we saw above, Goldilocks required unprecedented private sector deficits. It is not likely that the balance of payments will improve significantly, given that much of the world looks to the US to consume global “excess” production. The budget balance has moved sharply toward deficit as the economy deteriorated, from a surplus of nearly 3% of GDP to a deficit of 1.5% of GDP. However, it is normal in recessions for the private sector to retrench to a surplus of 3% or more of GDP (and,

as we saw above, the UK private surplus reached 9% after its experience with private deficits equal to 6% of GDP in the late 1980s). Given a balance of payments deficit of 4 or 5 percent of GDP, the government budget deficit would have to rise to 7 or 8 % of GDP to allow a private surplus of 3%. This seems unlikely in the current political environment—if it occurs, it will probably take place gradually and only as the economy tumbles into a deep recession that wipes out tax revenue. In other words, a large and growing deficit will almost certainly come to pass, but not as the result of decisive and discretionary fiscal policy, but rather as the result of a Japanese-like deterioration of the economy.

2. The question then becomes whether the private sector can provide the necessary aggregate demand, by continuing to run deficits of, say, 3 or 4 percent of GDP. This, in turn, would increase private sector indebtedness—beyond the record levels already achieved. Private sector debt-to-income ratios would probably continue to rise with deficits of this size, unless robust economic growth returned. There are several reasons to doubt that scenario. Firms are faced with excess capacity and have already downsized considerably (2 million jobs have already been lost). It will take some time to work off the excess capacity in a large number of sectors. Households have been on a durable goods and home buying spree for a several years; the value of a third or fourth refrigerator or SUV must, now, be fairly low. Perhaps as much as \$10 trillion dollars of wealth has been sucked from the economy due to the government budget surpluses and the stock market losses. It is commonly believed that much of the borrowing over the Clinton expansion was fueled by the “wealth effect” of the equity bubble, but that is surely finished (and probably grossly overstated—a recent study shows that in spite of the huge relative growth of income and wealth at the top of the distribution, consumption became only slightly more unequal, meaning that those who did not enjoy growth of either income or wealth were able to increase consumption as much as those who did, presumably by “democratization” of borrowing). Deflationary pressures around the globe are placing downward pressures on prices, wages, and domestic production. Cost cutting reduces nominal spending and income flows, which makes it increasingly hard to service debt—much of which was taken-on when expectations of rising income and wealth were predominate. Further, and somewhat ironically, US bankruptcy laws were recently revised to make it much more difficult to get out of debt commitments. The debt overhang will continue to burden households for years to come.

3. Whatever stimulation we might have gotten from monetary policy has (probably) already been reaped. There is little doubt that the Fed's loosening did encourage one last orgy of automobile purchases as well as helping to fuel a real estate bubble (that was already in process because wealth owners were seeking an alternative to the faltering equities market). As we have seen above, interest rate reductions do not usually have much impact on debt service ratios. In any case, the Fed now has only 125 basis points to go, having already lowered the rate some 400 bp. Further, the interest rate is mostly a distributive variable, so that reductions lower income of some groups while reducing debt service costs of others. Aside from encouraging rising net indebtedness, the stimulative impact from monetary policy must come from differential marginal propensities to consume. While the conventional wisdom is that the rentiers (those who receive interest income) have a lower MPC than do debtors, there is surprisingly little work on this. Given the enormous relative increase of interest income in the US as well as the aging of the population and the growth of pension funds, it is probably not safe to assume that interest rate reductions stimulate spending through income redistribution. Further, given the growth of sovereign debt in the postwar period, interest rate reductions automatically reduce government interest spending. In other words, an interest rate cut leads to fiscal austerity. Unless private spending increases by more than the reduction of public spending, the net effect of monetary ease could be negative. For the US, given that the outstanding federal government debt is now less than 30% of GDP, it is probable that interest rate reductions do have a marginally beneficial impact (again, the Fed has almost certainly achieved whatever stimulative impact possible through that avenue). However, with the debt ratios of Japan and many Euro states close to or above 100%, it is possible that monetary ease has a perversely negative impact on demand in those nations. Hence, raising interest rates could well be stimulative in a country like Japan because it is equivalent to a fiscal stimulus. (Conversely, with a debt ratio of 100% of GDP and with interest rates above 10% (say, Italy a decade ago), interest rate hikes could well lead to an inflationary spiral as well as a trend toward ever-rising budget deficits and debt ratios; it is likely that some Latin American nations have experienced this. The solution is to lower interest rates to cool the economy.)
4. Most US states are now facing a serious financial crisis. State revenues and spending are strongly pro-cyclical. Over the Clinton boom, they enjoyed exploding revenues (partly driven by taxes on gains deriving

from Wall Street) and cut taxes, helping to fuel the boom. As the economy slowed and as the capital gains tax windfall disappeared, state revenues collapsed. Because states must run (nearly) balanced budgets, they have been busy cutting spending, laying off workers, and raising taxes. Deficits threaten bond ratings and can easily put a state onto an unsustainable path with rising interest rates that generate ever-rising deficits and falling bond ratings that increase debt-service costs. This means that any government stimulus must come from the federal level, and must compensate for retrenchment at the state and local government level. Alternatively, any private sector-led expansion will have to suffer a drain of income and wealth as states try to restore finances and replenish “rainy day” funds; such blood-letting will make it more difficult to sustain such an expansion.

5. We have already examined the international level. Given the modern mercantilist stance of Japan and Euroland, as well as of much of the rest of Asia, and the fiscal austerity imposed by fixed exchange rates in much of the world, a slowdown of the US will almost certainly increase efforts around the globe to slow domestic economies in order to export their way to growth. This in turn will increase deflationary pressures around the globe as nations jockey for low-cost positions. The wide-spread belief that “flexible” resource markets and that “restructuring” and other supply-side policies provide the only solution to what is at bottom an aggregate demand problem will contribute to this problem. Cost-cutting (layoffs, wage and benefit cuts, higher productivity) only depresses demand and increases excess capacity in such an environment. Euro states will likely find themselves in positions similar to those of American states, with falling bond ratings and rising interest rates and budget deficits in a vicious circle.

CONCLUSIONS

A variety of forces have led to tight government budgets in the US and abroad. The early “Keynesian” postwar belief that balance should be achieved only during robust expansion as the economy achieved full employment was replaced by the belief that structural surpluses are normally desired. As we have seen, this necessarily implies that the private sector run structural deficits—made even worse for countries like the US that run balance of payments deficits.

One of the chief justifications for budget surpluses is the claim that these can add to national savings; a subsidiary (but increasingly important) claim is that national savings are needed to provide for future retirees. We hope we have made it clear that such thinking is hopelessly confused. Budget surpluses can only substitute for private sector surpluses; it is not possible for them to do anything but “subtract from” private surpluses unless they somehow cause the country can run a balance of payments surplus equal to the sum of the government and private surpluses. While one might concoct a (coherent?) story about how public surpluses generate trade surpluses (such a story was told in the US in the early 1980s), even if that were true it cannot be a solution at the global level for the simple reason that BP surpluses must be offset by BP deficits. With all nations trying to run budget and BP surpluses, many are doomed to fail with such a “beggar thy neighbor” policy.

Further, in spite of all the claims that government budget deficits are “unsustainable”, any reasoned analysis would conclude that private sector deficits cannot be more sustainable than deficits of sovereign nations. History is certainly on the side of such analysis: the US has experienced only six periods of sustained public sector surpluses (and, hence, sustained deterioration of private balances), and each of these was followed by one of our six depressions. As figure 1 above showed, each (brief) public sector surplus and private sector deficit in the postwar period was followed by a recession and explosion of government deficits as the private sector’s balance turned toward large surpluses. Finally, the UK and Japanese experiences with budget surpluses (and in the case of the UK, large private deficits; Japan’s private sector did not experience deficits because of the large BP surplus) followed by deep recessions (that of course continues in Japan) also justifies the belief that government surpluses and private deficits are highly unsustainable.

This point was recognized by Hyman Minsky as early as 1963. As is well known, he analyzed each economic unit as a “money-in, money-out” entity, and as he wrote in 1963, “each liability emitter attempts to arrange his receipts and spending so as to be able to meet his commitments.” (1963, p. 412) Even from his earliest analyses, Minsky emphasized the important role played by margins of safety. In an expansion fueled by the private sector, these margins of safety would be (intentionally) reduced. However, Minsky contrasted this with a government-spending-led expansion: “During a protracted expansion dominated by household and business deficits the ratio

of household and business financial commitments to income rises, whereas in an expansion dominated by government deficits the ratio of private commitments to income decreases.”

Hence, not all expansions are created equal--an expansion that is led by private sector deficits is inherently unstable and unsustainable because “the greater the payment commitments relative to expected receipts the greater the reluctance and the smaller the ability of a private unit to finance its operations by deficits.” There is no fine rule governing willingness and ability to deficit spend. Prospective income flows, expected capital gains, interest rates and debt service ratios, confidence and euphoria, custom and attitudes toward risk and uncertainty, and expected continued access to credit on reasonable terms are all important determinants. He argued that over the course of an expansion, economic units would take increasingly fragile positions, especially if the expansion were led by private sector spending.

The final point to be made is that society does not provide for future retirees through “saving”. Neither private saving nor public saving can do such a thing. Society provides for the future through investment in private and public infrastructure and in what will become its future workforce (child-rearing, education, training). If it were true that public or private saving somehow promoted such activities—perhaps indirectly—then there could be a justification for policies geared toward promoting saving. But few if any arguments advanced to date are coherent, much less plausible. It should be clear that public surpluses cannot lower interest rates by increasing national savings—for the simple reason that they cannot increase national savings. Further, as we have argued above, any sovereign nation with a floating currency can have whatever overnight rate it wants; overnight rates are exogenously set.

It is true that this does not apply to nations that have decided to fix exchange rates; in these nations, overnight rates are set while taking into account possible effects on exchange rates. Further, in such nations, budget deficits may well affect government borrowing rates as bond ratings fall while budget surpluses enhance bond ratings and lower borrowing rates. Hence, for nations on fixed exchange rates, it may be true that “public saving” affects government borrowing rates.

There still remain three barriers that prevent this from increasing the capacity to provision for the future. First, budget surpluses might require less spending on public infrastructure, education, and training. This could be compensated by private sector spending in these areas; the problem is that public sector surpluses imply deterioration of private sector balances. Hence, the private sector might experience rising borrowing costs and increasingly fragile financial positions—not the sort of environment that would encourage such spending. And, finally, empirical studies have not demonstrated that such spending is very interest-sensitive in any case, so that even if private borrowing costs fall this would not encourage much private investment.

The best way to encourage high private investment is to maintain strong aggregate demand. This in turn requires an appropriate budget stance. To be sure, government deficits are not appropriate to all situations. A nation like Ireland today with a strong balance of payments surplus might require a restrictive fiscal stance. One could even argue that a budget surplus at the peak of the US Goldilocks boom was appropriate, if the economy was on the verge of an inflationary spiral; while we do not believe that there was any real danger of over-heating, we concede that there was at least some evidence in favor of that argument. Still, the argument about provisioning for the future has to do with the structural budget stance and not with the cyclical budget. As Minsky argued, structural growth in the presence of government budget surpluses is inherently risky; his argument is made altogether stronger for the case of a nation that will run BP deficits at anything approaching full employment.