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The U.S. Fiscal Situation

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Disclaimer

Disclaimer: The views expressed are those of the author and do not necessarily reflect those of the Federal Reserve Bank of St. Louis or the Federal Reserve System. Really.

I thank Brett Fawley for excellent assistance in putting this presentation together.

The Agenda

- Government budget constraints
- Debt Complications
- U.S. budget history
- Current U.S. fiscal situation
- An international comparison
- Resolutions of the U.S. Fiscal Situation?
- Where does the money come from and where does it go?

The Government Budget Constraint

- The present value of total expenditures (forever) cannot exceed the present value of taxes (forever).
 - A government doesn't have to balance its budget every year; neither does your family.
 - Governments live approximately forever. (Or something close.)
- Balanced budgets aren't necessary or wise.
 - Reasons for unbalanced budgets: Recessions, wars, capital investments and demographic imbalances.

An Aside: Debt Complications

- How should we count things? How to measure debt?
 - Capital budgeting: Investment versus consumption.
 - Future liabilities: E.g., Social security and Medicare.
 - Gross versus net debts
 - Net debts subtract government assets (e.g., FX reserves) from total debt.
 - U.S. debt is complex.
 - Include state/local debt and net out government/Fed held debt.

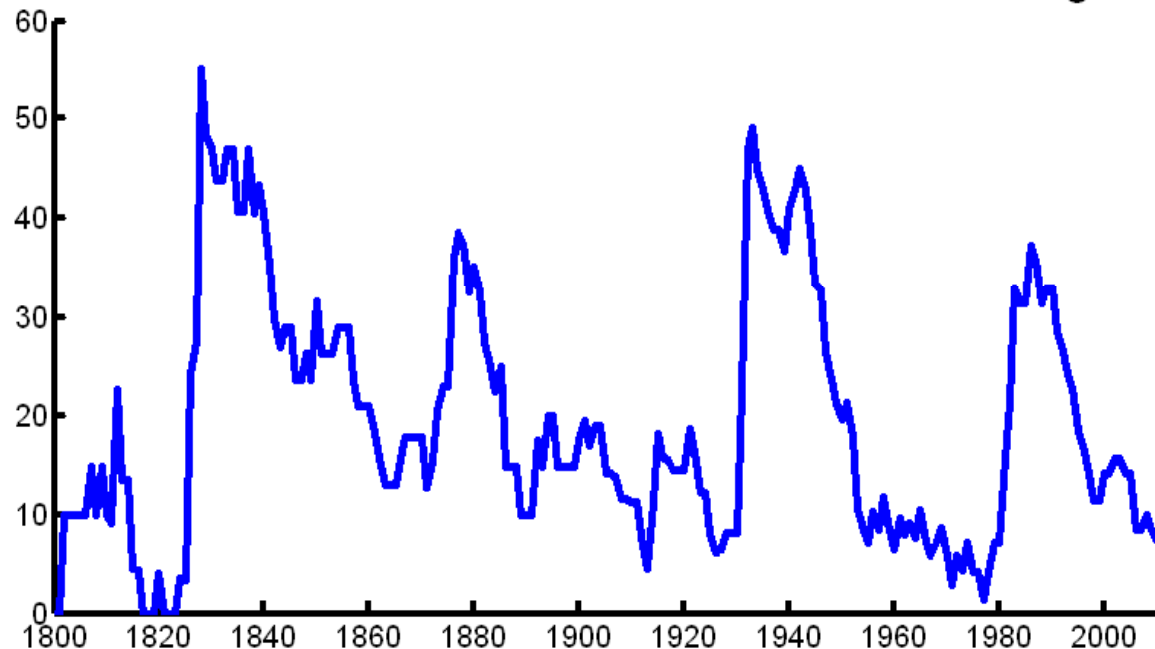
The Government Budget Constraint

- Benjamin Franklin believed in balanced budgets, period by period.
 - “Neither a borrower nor a lender be.”

The Government Budget Constraint

- Government defaults are common.
 - See Reinhart and Rogoff: “This Time Is Different.”
 - Explicit vs. implicit (inflation) defaults.

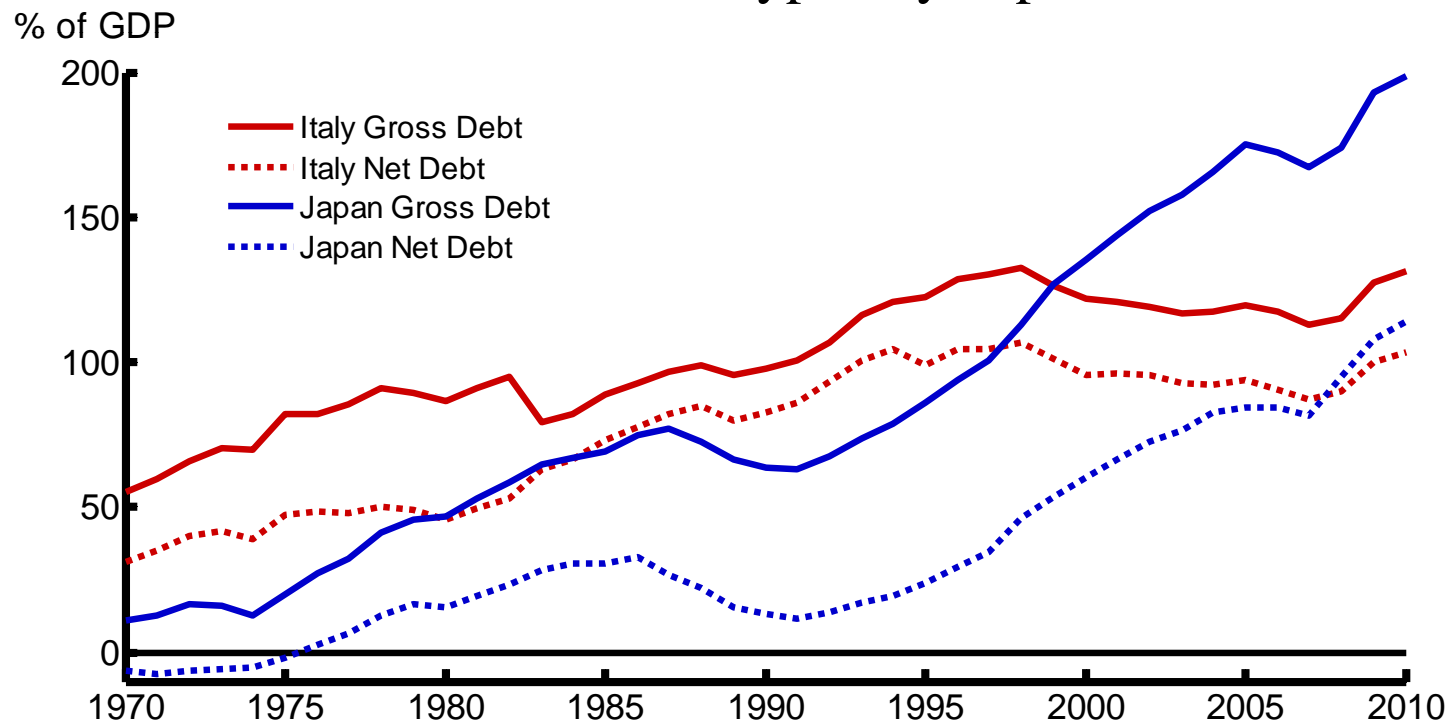
Percent of Countries in Default or Restructuring



Source: This Time Is Different: A Panoramic View Of Eight Centuries Of Financial Crises, Carmen M. Reinhart, Kenneth S. Rogoff, WP 13882
<http://www.nber.org/papers/w13882>

The Government Budget Constraint

- How large of a deficit/debt can a country run?
 - Deficits and debts are typically expressed as a % of GDP.

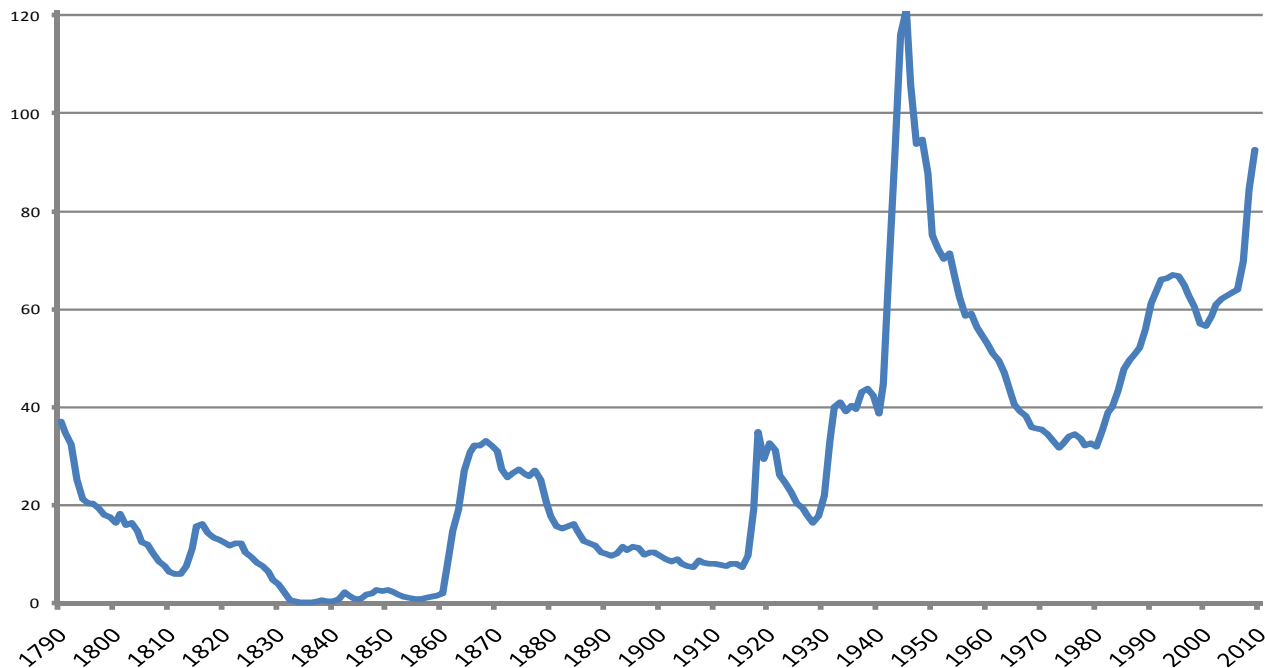


Source: OECD
Economic Outlook

U.S. Historical Gross and Net Federal Debt

Debt climbed during war and slowly fell during peacetime until the 1980s.

U.S. Gross Government Debt as a % of GDP

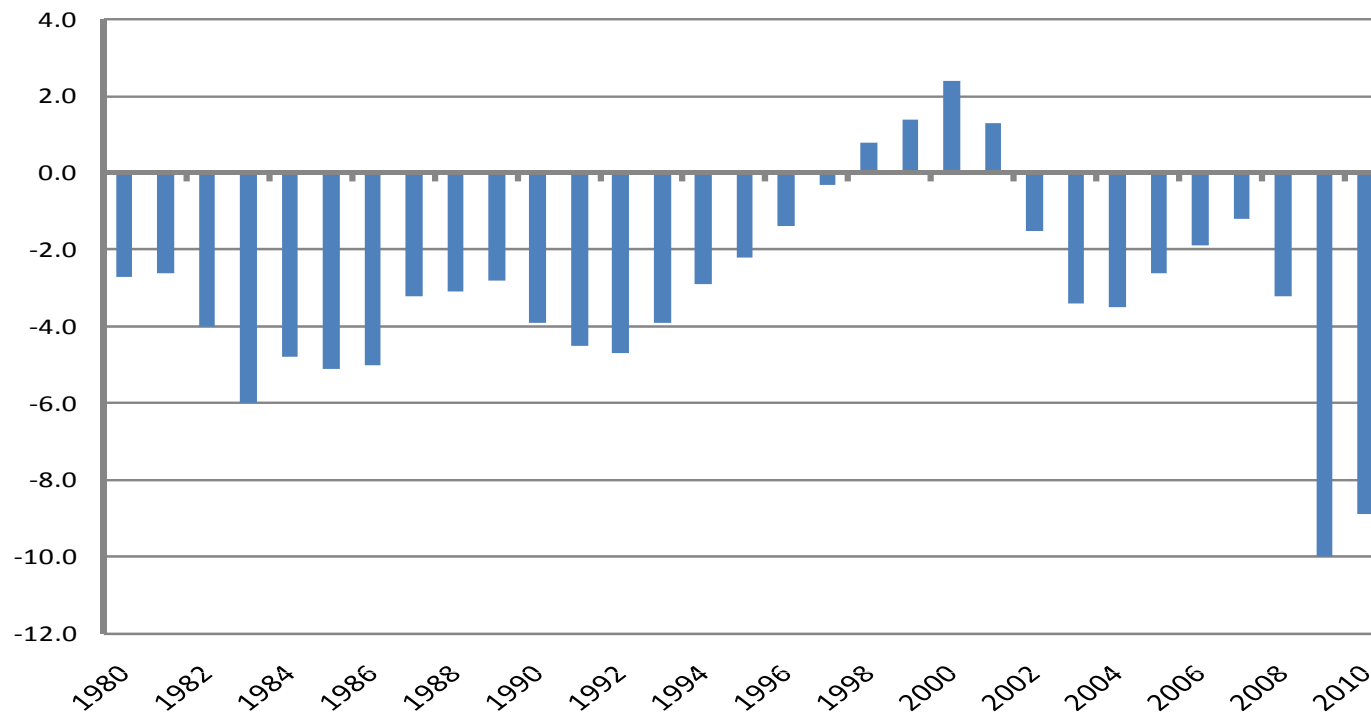


Source: U.S. Treasury and Louis Johnston and Samuel H. Williamson, "What Was the U.S. GDP Then?" Measuring Worth, 2010.

U.S. Historical Gross and Net Federal Debt

Recent deficits are completely unprecedented in peacetime.

U.S. Federal Deficits (% of GDP)



Source: OMB

What is the U.S. Fiscal Situation?

An International Comparison

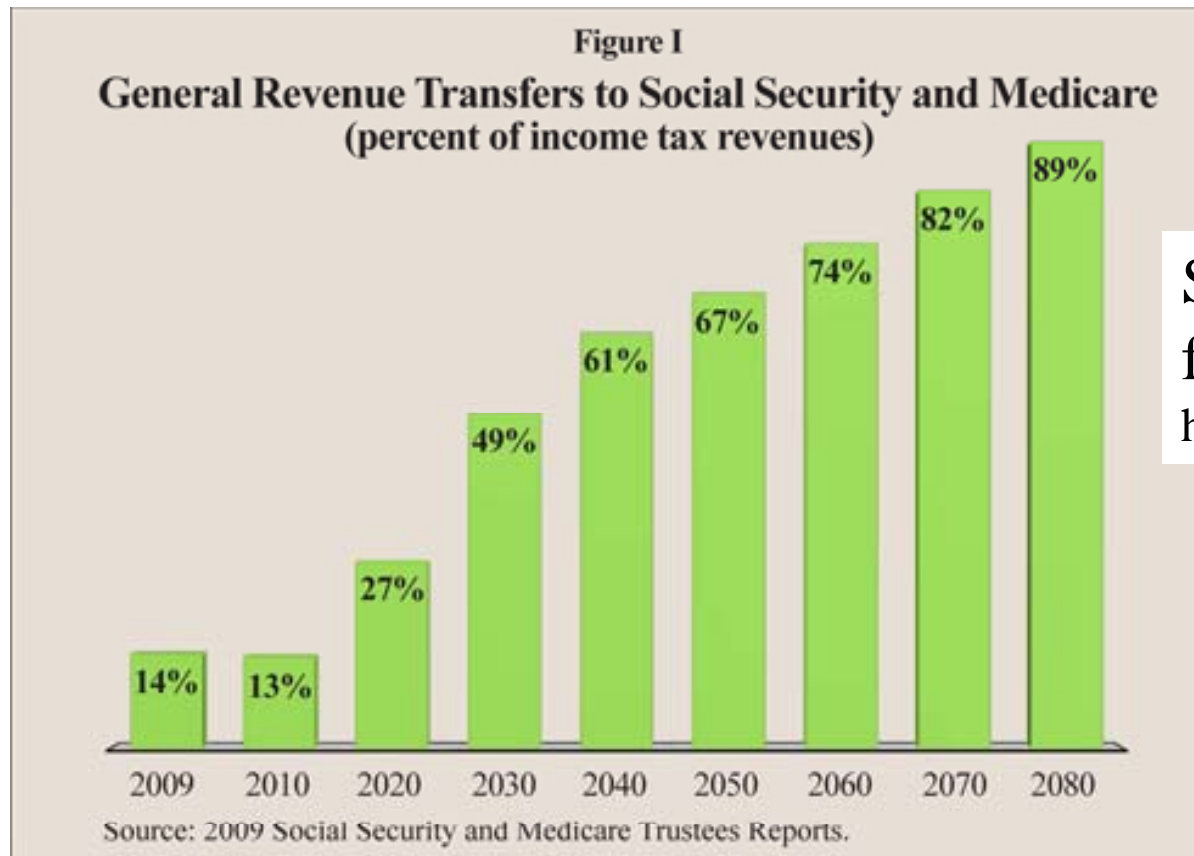
- Federal problems
 - Large deficits
 - Projected debt-to-GDP rising from 60 to 185 by 2035.
 - Serious long-term challenges over Medicare/Social Security.
 - Short term problems are resolvable; the long-term situation is more serious.
- There are also big State problems
 - Discussions of state “bankruptcy.”

What is the U.S. Fiscal Situation?

Not good at all

- Medicare is the big long-term problem.
 - Structural problem: Economic & technological growth lead us to want to pay a higher fraction of our income for medical care.
 - A third party payer removes a check on growth.

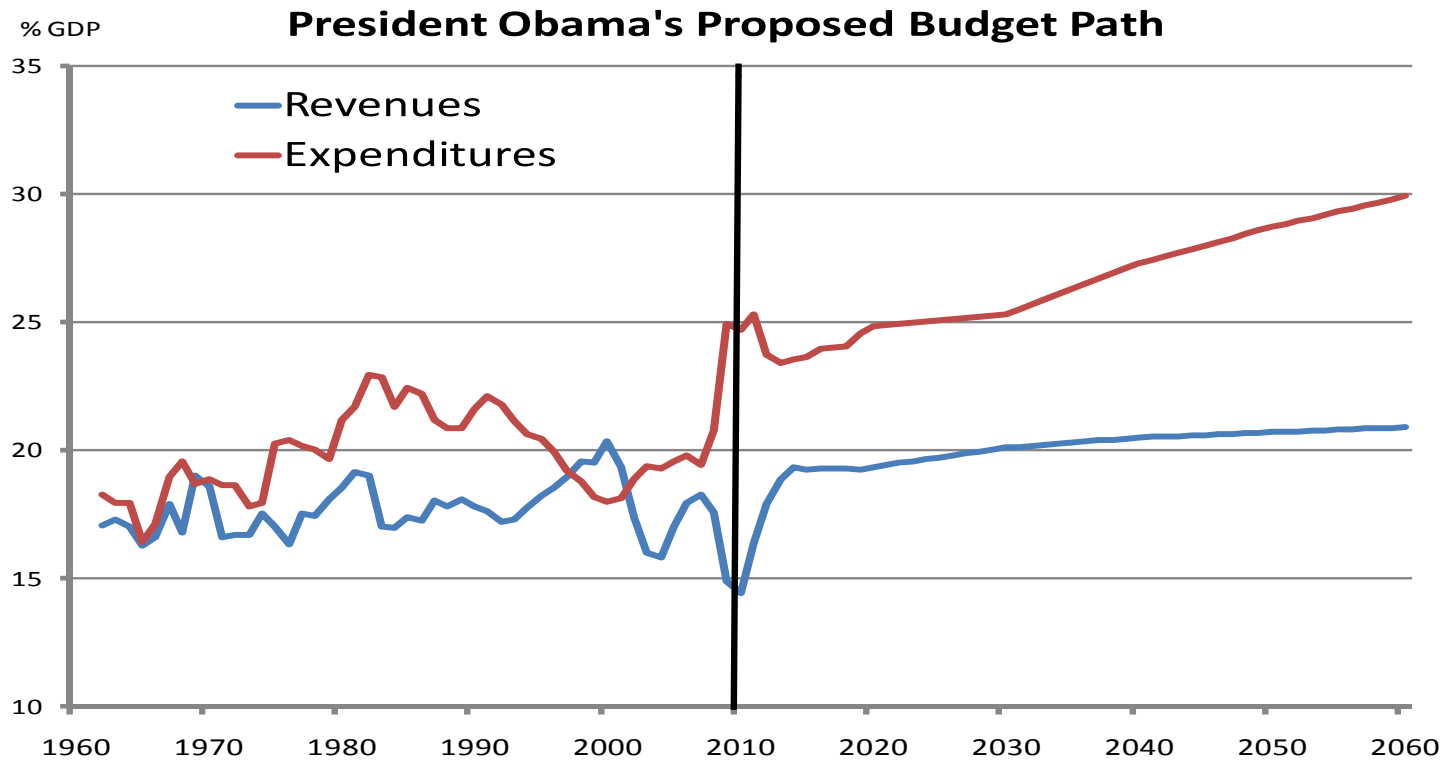
The Coming Problems with Social Security and Medicare



Source: National Center
for Policy Analysis
<http://www.ncpa.org/pub/ba662>

U.S. Historical Gross and Net Federal Debt

US net debt/GDP expected to rise from 60 % in 2010 to 185 % by 2035.



Source:
FY12 Budget, GPO

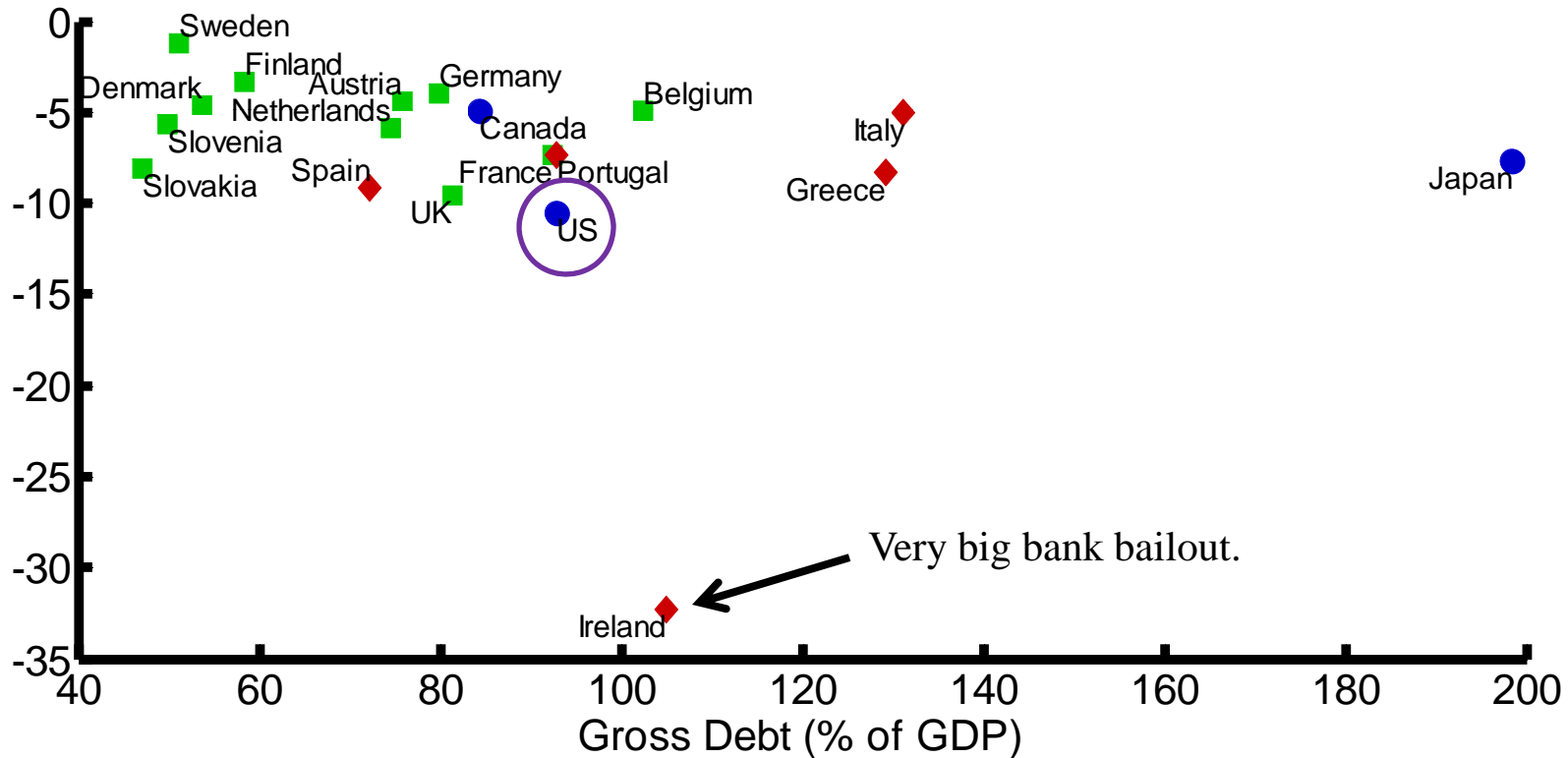
What is the U.S. Fiscal Situation?

An International Comparison

- The U.S. has very large deficits and fairly large debt ratios compared to other developed countries.
- Less developed countries cannot accumulate so much debt.
- The U.S. is helped by its size and reputation for not defaulting.

Current Deficits v. Gross Debt

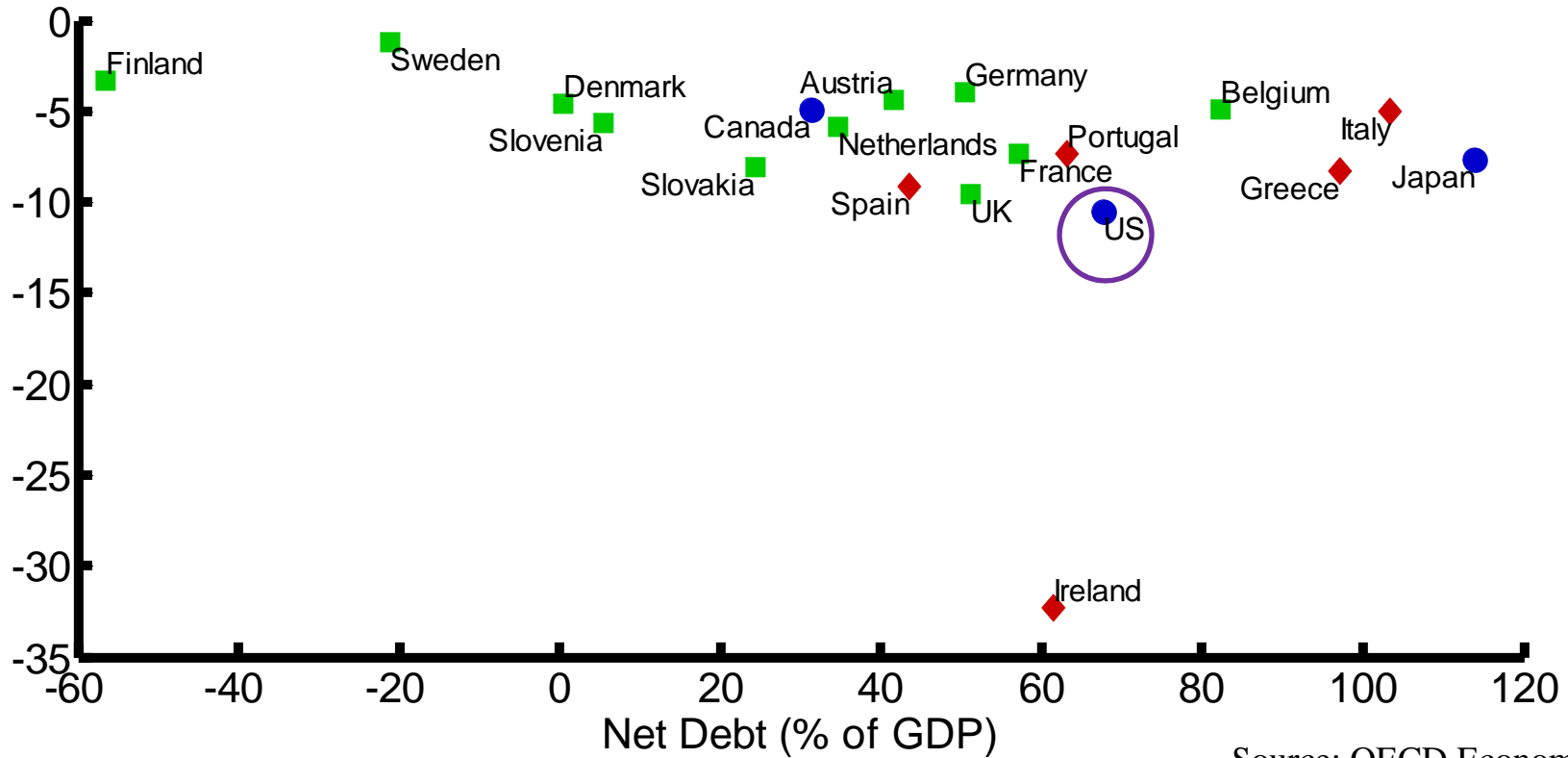
Current Deficit
(% of GDP)



Source: OECD Economic Outlook

Current Deficits v. Net Debt

Current Deficit
(% of GDP)



Source: OECD Economic Outlook

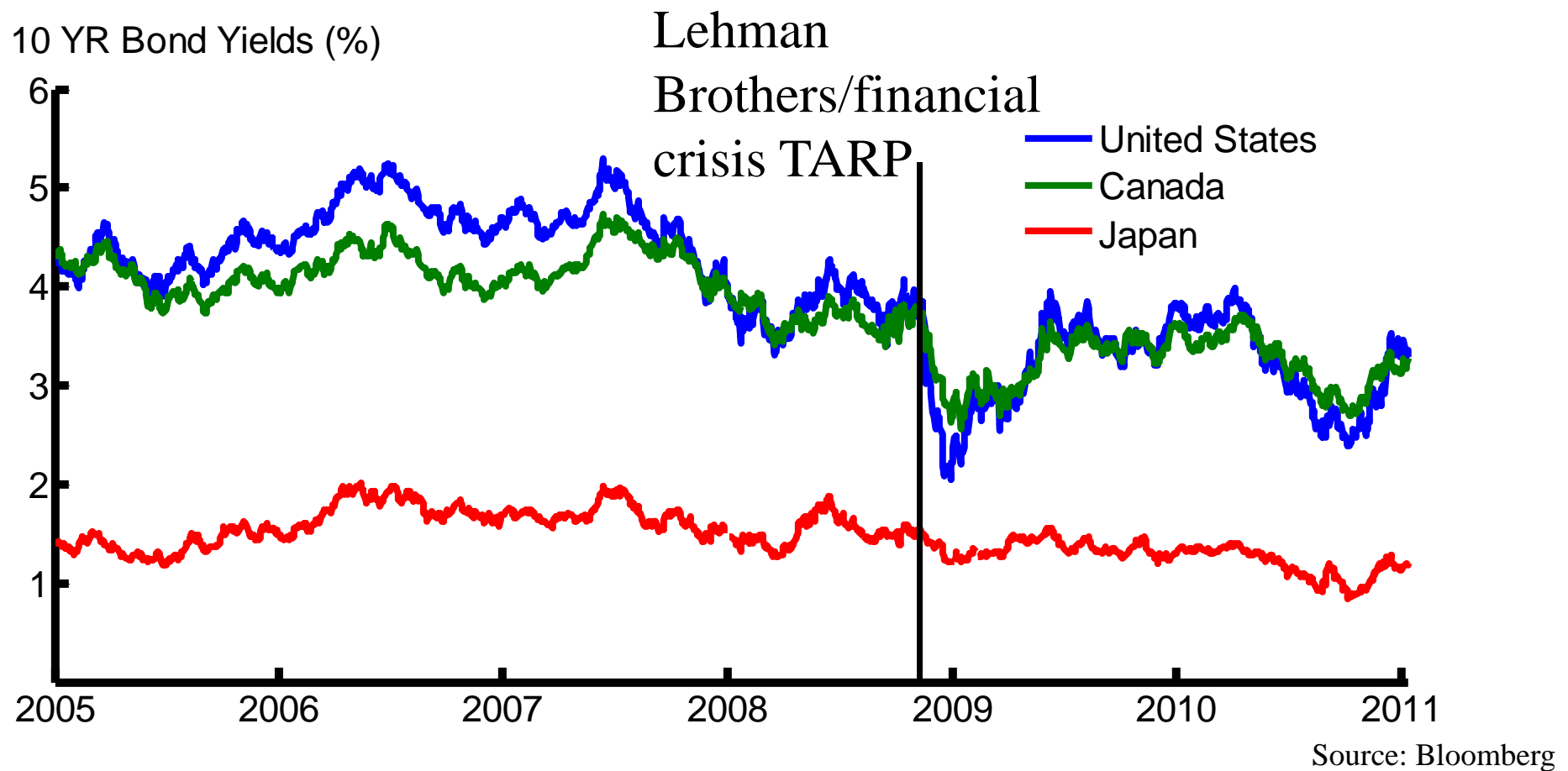
Resolutions of the U.S. Fiscal Situation?

- There are three ways that the U.S. fiscal situation might be resolved.
 - A change in tax/spending policies that makes the fiscal situation sustainable.
 - An explicit default. (Very bad.)
 - Markets place a low probability on this outcome.
 - CDS rates have risen substantially but are still fairly low.
 - An implicit default through inflation. (Also very bad.)
 - Markets do not seem to believe this.
 - Expected inflation is low. No chance of “implicit” default through substantial inflation.
 - The U.S. debt structure would make this very difficult.

Resolutions of the U.S. Fiscal Situation?

- Why can't the Federal government simply print dollars to pay for what it needs to buy?
 - Bad idea: This would quickly lead to hyperinflation.
 - This has been done in many countries and is well understood.
- Isn't that what the Fed is doing with its QE programs?
 - No, QE are temporary purchases and current circumstances allow the Fed to keep the QE purchases from increasing the broader monetary aggregates.
- So what good is QE if it is temporary and doesn't affect broader monetary aggregates?
 - It reduces long term interest rates and increases investment projects.

What Effect have these Deficits/Debts had on Bond Yields?

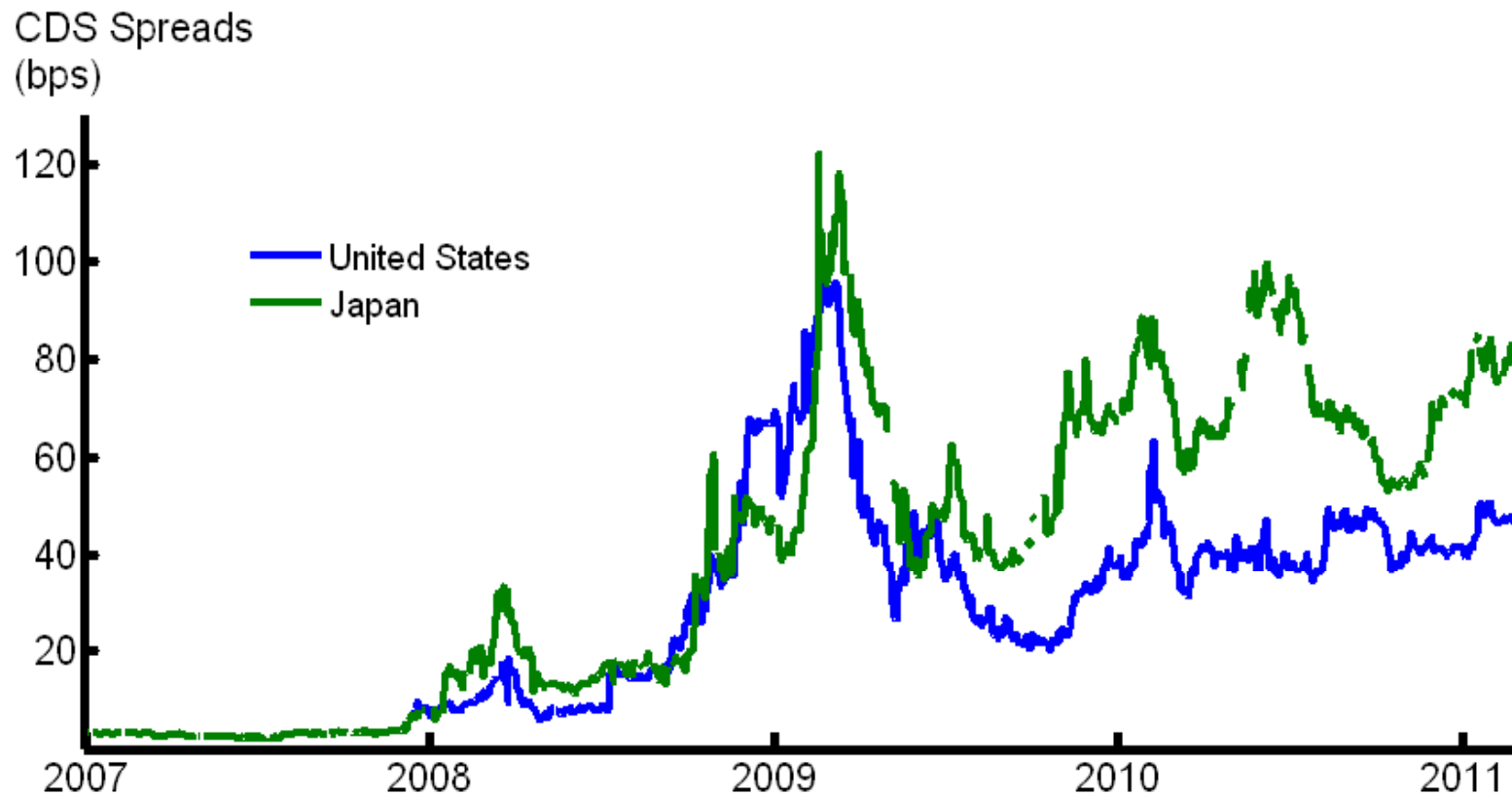


What are CDS Rates?

- CDS: Credit default swaps.
- CDSs function much like insurance for bonds.
 - The buyer pays an annual premium in exchange for the seller's agreement to buy the bond at face value (par) if the bond issuer defaults.
- One can use CDS rates to derive “risk-neutral” probabilities of default.
 - What are “risk-neutral” probabilities?



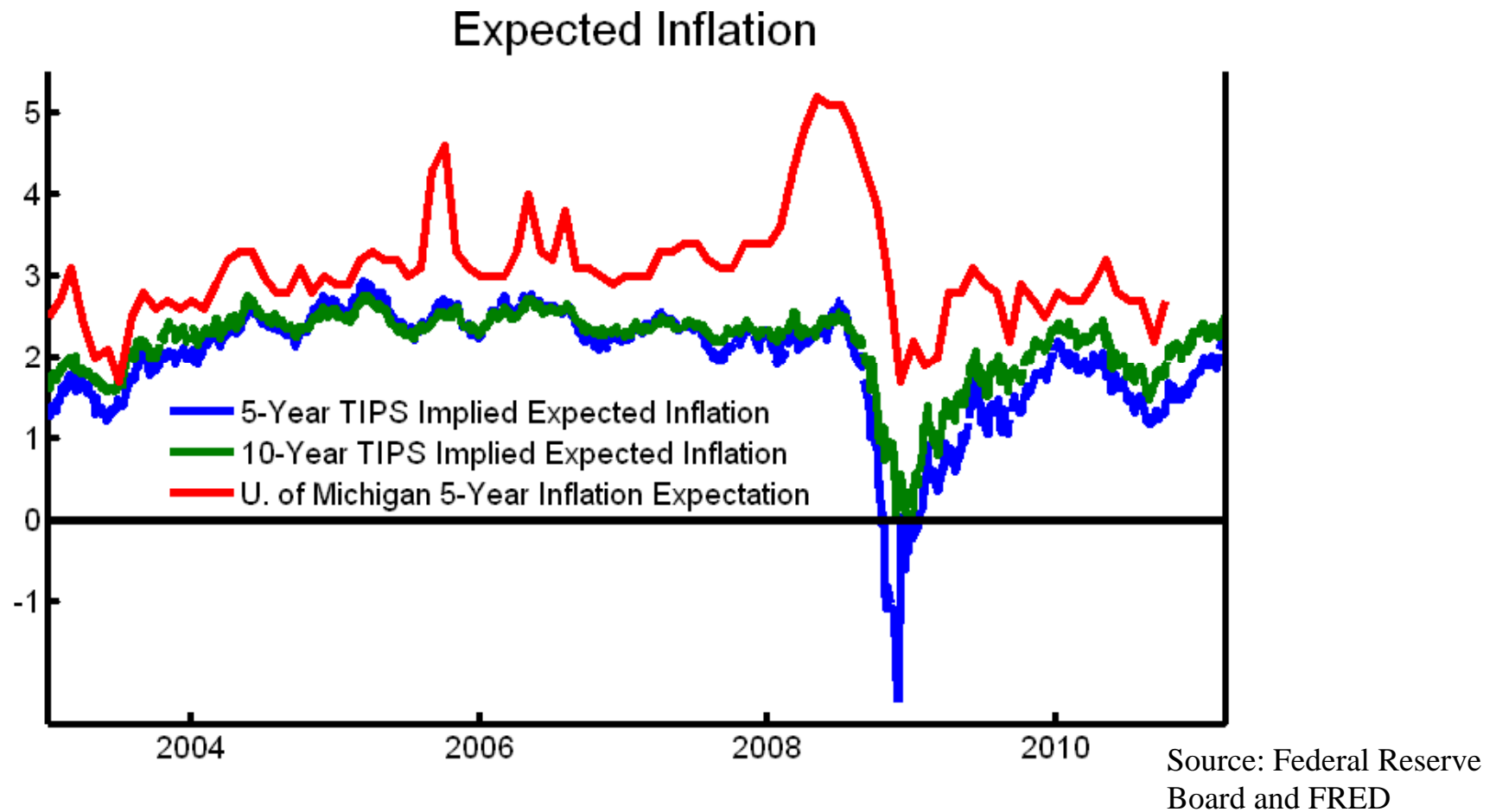
What Effect have these Deficits/Debts had on CDS Rates?



Source: Bloomberg

What is the U.S. Fiscal Situation?

Not good at all



Country	Credit Rating		
	Moody's	Standard and Poor's	Fitch
United States	Aaa	AAA	AAA
Canada	Aaa	AAA	AAA
Japan	Aa2	AA	AA
Austria	Aaa	AAA	AAA
Denmark	Aaa	AAA	AAA
Finland	Aaa	AAA	AAA
France	Aaa	AAA	AAA
Germany	Aaa	AAA	AAA
Netherlands	Aaa	AAA	AAA
United Kingdom	Aaa	AAA	AAA
Poland	A2	A	A
Slovakia	A1	A+	A+
Portugal	A1	A-	A+
Italy	Aa2	A+	AA-
Ireland	Baa1	A	BBB+
Greece	Ba1	BB+	BB+
Spain	Aa1	AA	AA+
Belgium	Aa1	AA+	AA+

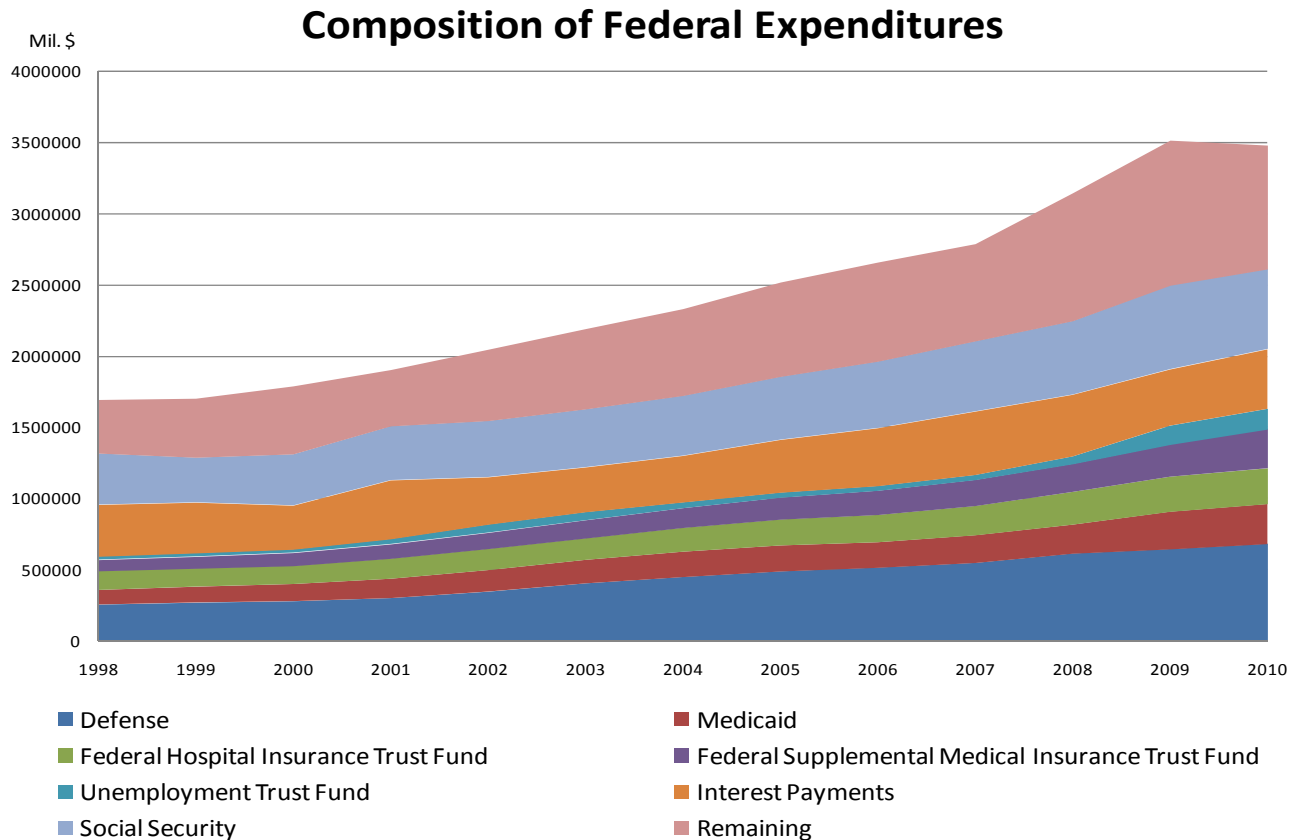
The U.S. Fiscal Situation

- Where does the money go?
 - Federal: Defense, Interest payments, Social Security, Medicare and Medicaid
 - State: Welfare, schools, hospitals, highways.

- Where does revenue come from?
 - Federal: Personal income taxes, payroll taxes and corporate income taxes.
 - State: Sales taxes, personal income taxes, corporate income taxes.

What does the Federal Government buy?

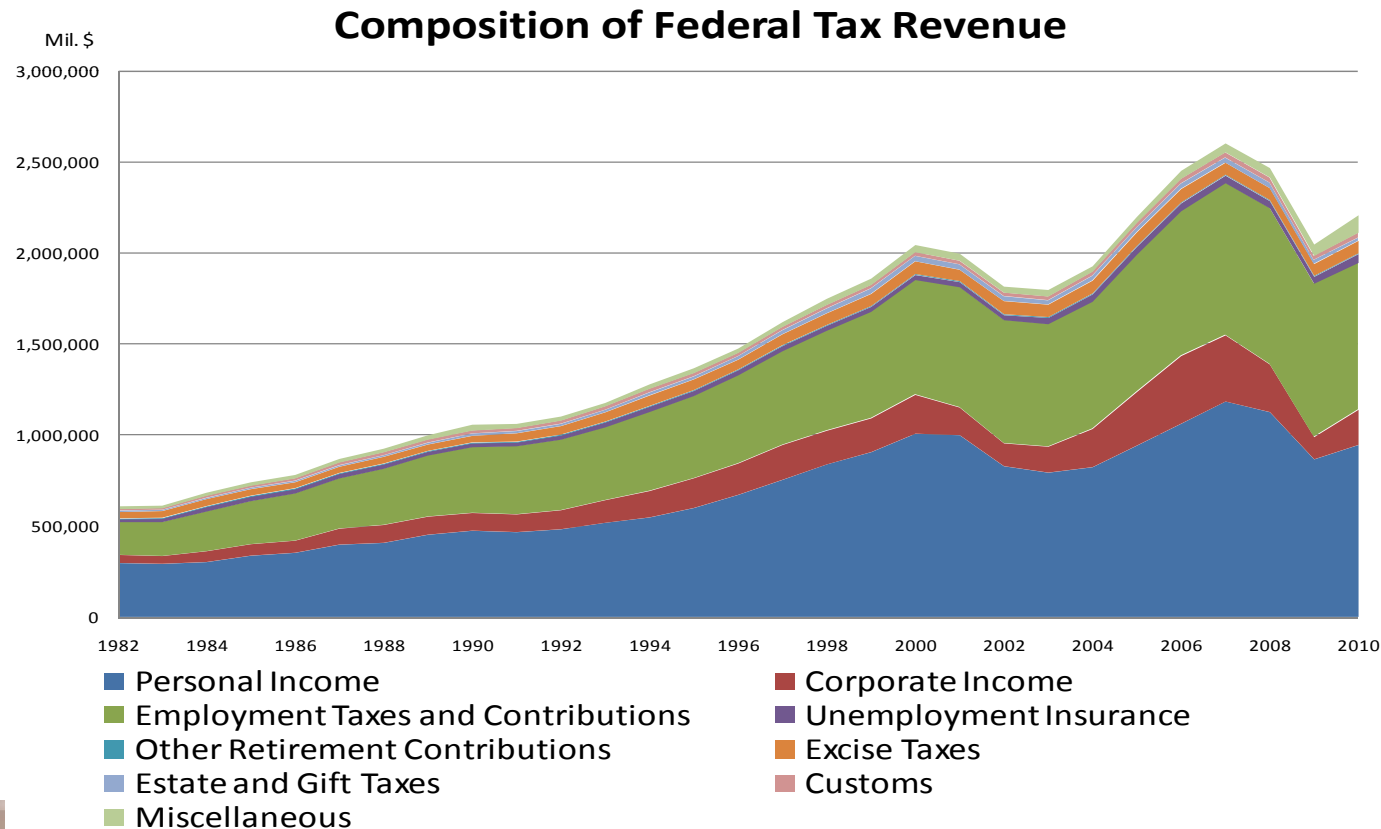
Defense, Interest payments, Social Security, Medicare and Medicaid



Source: U.S. Treasury

Where does Federal revenue come from?

Personal income taxes, payroll taxes and corporate income taxes.

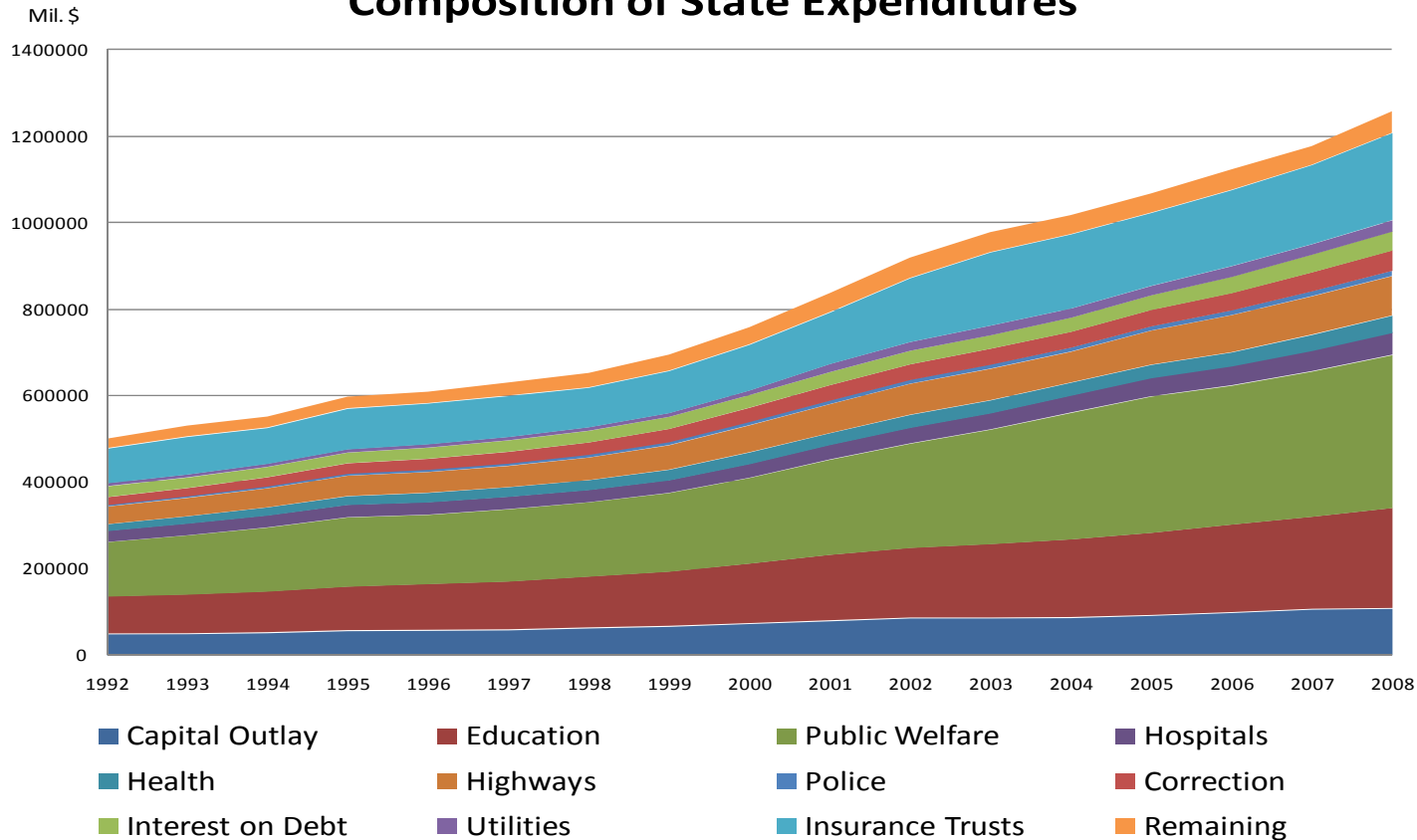


Source: U.S. Treasury

What do State Governments buy?

Welfare, schools, hospitals, highways.

Composition of State Expenditures

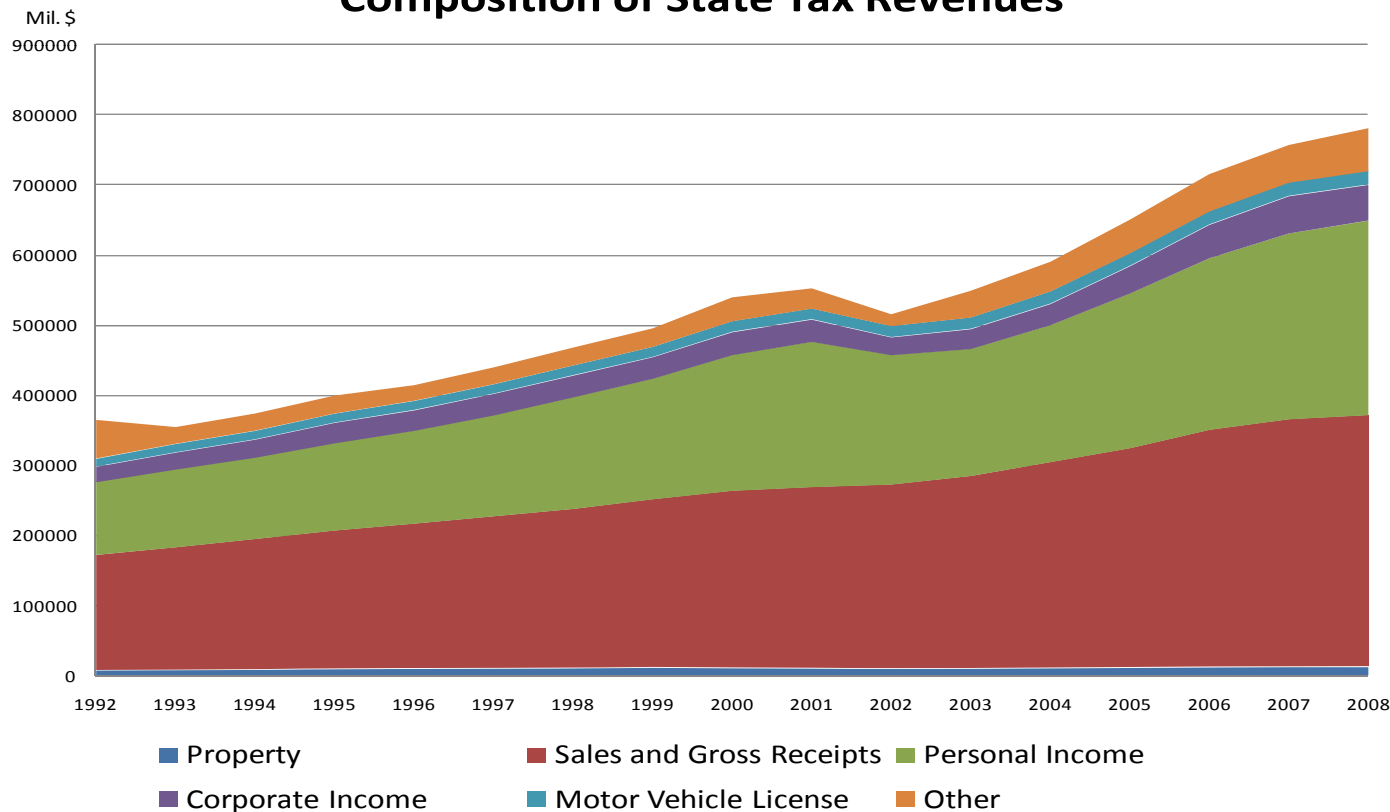


Source: U.S. Census

Where does state revenue come from?

Sales taxes, personal income taxes, corporate income taxes.

Composition of State Tax Revenues



Source: U.S. Census

U.S. Strength

- Difficult for international bond buyers to find enough good substitutes for U.S. government debt.
 - There are few options: the euro, the yen, the pound.
 - The “Officer and a Gentleman” scenario: “I’ve got nowhere else to go.”

The Bottom Line

- The United States faces a difficult fiscal situation.
 - The financial crisis has strongly affected short-run budgets.
 - The long run is actually a more serious problem.
 - Medicare growth, social security.
 - States share in these problems.
 - Markets still place a low probability on the possibility of a U.S. default, either implicitly or explicitly.
- The U.S. has benefitted to some extent from the PIIGS problems.

The End