

Notes on the Fiscal Deficit of the U.S. and the Future of the Dollar - Part 1

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Over the last decade, much of the academic discussion in the economic arena remained concentrated on the topic of the growing current account deficit of the U.S. and its implications for the global configuration of trade surpluses and economic growth patterns. The international context during this period was characterized by 3 interconnected trends.

The first trend was the consistent expansion of the current account deficit of the U.S. throughout the last decade, reaching a historical record of 5.9% of GDP in the fourth quarter of 2006. The implication of this development was that by 2008, the U.S. attracted 43% of the global capital flows. The counterpart of this phenomenon was the rise in China's and oil-exporting countries trade surpluses. These countries exported 52.6% of total capital flows in 2008 (IMF 2009: 167).

The second trend is the massive accumulation of international reserves by countries with trade surpluses. Thus, China's international reserves increased fivefold over the past 5 years, rising from 410 billion dollars in 2003 to 2,134 billion dollars in late 2008. In the case of oil exporting countries, the increase was of a similar scale, rising from 290 billion to 1,480 billion dollars during the same period (IMF 2009b: 214).

The third trend is the persistent decline in the value dollar over the decade. To the extent that economic recovery from the recession of 2001 took place, the dollar experienced a nominal depreciation of nearly 30% between 2002 and the second quarter of 2008 (IMF 2009: 169).

Taken together, these elements led several observers to declare that a disorderly re-balancing of global current accounts was a disaster waiting to happen (Cline 2005). This position was based on the perception that the growing dependence of the U.S. to finance its deficit from a dwindling group of creditors would force the latter to undertake a process of diversifying their investment portfolio with the objective of reducing exposure to the U.S. dollar. In a context characterized by a plummeting dollar, reduced demand for dollar denominated assets would bring about an increase in interest rates, as international investors would seek compensation for the increase in perceived risk. Rising interest rates would have a devastating effect on the U.S. financing requirements, as ever increasing resources would be required to repay the funds received from abroad. Simply put this would amount to a massive international Ponzi scheme, in which the U.S. would play the role of fraudster in charge of the scheme.

Furthermore, the bulk of the attention of major international financial organizations focused on monitoring the evolution of global current account balances, as well as the inflationary effects of the enduring economic cycle, as the main threats to the

global economy in the short run. This left the dangers associated with the massive expansion of financial derivatives in the developed economies as a largely unnoticed and underestimated threat.¹

As the economic situation in the U.S. turned for the worse in the middle of the crisis, the attention quickly shifted to the freezing of international credit markets, leaving aside the issue of global macroeconomic balances. It is only in the context of the apparent stabilization of financial markets and the first signs of economic recovery that the topic was again included in the discussion agenda, in the recent G20 meeting in Pittsburgh, (Munchau 2009).

However, the current discussion has a slightly different tone. In the period before the financial crisis the focus of concern was the deterioration of the net investment position of the U.S.; at the present time the center of attention is the massive increase in U.S. fiscal deficit and its implications for the fiscal sustainability in the medium and long term as well as for the value of the dollar.

In the current situation the argument runs in the following lines: the massive issuance of treasury bonds of the U.S. required to finance the projected deficit over the next decade would cause a fall in price and hence a rise in their yields, to the extent that international investors perceive that the solvency of the U.S. Treasury is in jeopardy. In turn, rising interest rates would further weaken the precarious fiscal situation creating a vicious circle that eventually would end up with the declaration of insolvency of the U.S. and the end of the supremacy of the dollar in the global economy.

The aim of the present paper is to analyze the validity of this argument. Our claim is that concerns about a fiscal crisis in the U.S. in the medium and long term are largely unfounded. Although the massive increase in the fiscal deficit will take the national public debt of the U.S. to levels not seen since World War II, this occurs in a special context characterized by an overall decline in private consumption investment. As demonstrated by the Japanese experience over the past 2 decades, a significant increase in public debt in this type of context does not necessarily lead to a rise in interest rates or inflation to the extent that government deficit spending prevents recession to turn into an outright depression. More specifically, deficit spending allows the accumulation of surpluses in the private sector that is required to restore the balance sheets of households and corporations in order to provide a solid base for a more balanced path of growth.

The paper is organized as follows. Section 1 analyzes the evolution of the fiscal deficit of the U.S. and the public debt of that country, from a historical perspective. The second section highlights the similarities between the current situation of the U.S. economy and that of the Japanese economy after the collapse of its housing bubble in the

¹ Both the IMF and the World Bank underestimated the threat represented by the collapse of the subprime housing bubble as a minor risk up until late 2007. With the exception of the BIS, no other multilateral organization recognized the extent of the threat of financial derivatives to the stability of global financial systems (IMF 2007; World Bank 2007:8; Tett 2009: 152-155)

late eighties. In the third and last section, we study the structural changes that are taking place in the U.S. economy as a result of the financial crisis and how they alter the financing scheme of the fiscal deficit and therefore the value dollar.

The fiscal deficit of the U.S. in Perspective

According to projections from the Congressional Budget Office (CBO), the U.S. fiscal deficit for 2009 reached 11.2% of GDP, an historic high in the postwar period (CBO 2009: 2). Looking back at history, it is only in the context of the war effort of World War II that the country experienced higher deficits, averaging 22% of GDP between 1941 and 1945.

Table 1 – U.S Fiscal Deficit and Public Debt 2008 - 2019

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Total 2010- 2019
Revenues	2524	2100	2254	2717	3010	3221	3403	3577	3737	3808	4081	4250	34177
Expenditures	2983	3688	3644	3638	3600	3759	3961	4135	4358	4534	4703	4982	41314
Fiscal Deficit													
Billions of Dollars	-459	-1,587	-1,381	-921	-590	-538	-558	-558	-620	-626	-622	-722	-7,137
% of GDP	-3.2	-11.2	-9.6	-6.1	-3.7	-3.2	-3.2	-3.1	-3.3	-3.2	-3.1	-3.4	-4.00%
Public Debt													
Billions of Dollars	5,803	7,612	8,868	9,782	10,382	10,870	11,439	11,986	12,581	13,174	13,611	14,324	n.a.
% of GDP	40.8	53.8	61.4	65.2	65.9	65.5	66.0	66.5	67.1	67.5	67.0	67.8	n.a.

Source: CBO (2009)

Table 1 shows the official projections for the fiscal deficit and public debt of the U.S. over the next decade. Three elements can be highlighted in the table. The first is the significant increase of the fiscal deficit between 2008 and 2009, as it grew from 459 billion dollars to 1587 billion. This phenomenon is explained, on the one hand, by a 17 percent fall in revenues (the largest drop recorded since 1932). The reduction in the revenues, of nearly 400 billion dollars, came as a result of lower tax collection due to the collapse of economic activity. On the other hand, expenditures expanded a staggering 24 percent (the largest increase since 1952).

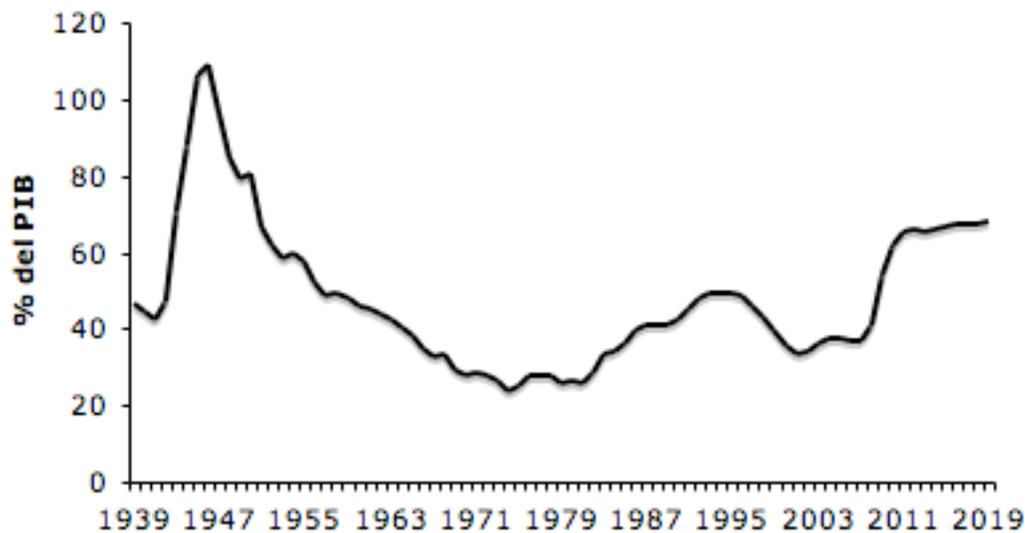
For the most part the programs associated with the rescue packages implemented during the financial crisis in 2008 explain the 700 billion dollars increase in expenditures during the 2009 fiscal year. Taken together, the nationalization of Fannie Mae and Freddie Mac, and the TARP (Troubled Asset Relief Program) represented an outlay of 424 billion dollars (CBO 2009: 8). The stimulus program ARRA (American Recovery and Reinvestment Act) represented a further expansion of expenditures accounting for another 130 billion dollars. In the meantime, unemployment benefits rose by 73 billion dollars, as the ranks of the unemployed have swelled affecting 10% of the working force (CBO 2009: 9). While the increase in resources allocated to protect lay off workers is undoubtedly good news, it is noteworthy that those resources represent only about 10%

of the total increase in expenditures and 15% of the rescue packages for the financial system and the stimulus program.

The second element to highlight from Table 1, is the progressive reduction of the fiscal deficit over the next decade. The significant reduction in the deficit starting in 2011 is related to the expiration of the tax cuts implemented by the Bush Administration between 2001 and 2003. It is expected that taxes on individuals, that currently represent 6.5% of GDP, will gradually increase to up to 10.8% in 2019. This will represent a key element of the policies to reduce the fiscal deficit (CBO 2009: 14).

Finally, the third element is the steady growth of public debt, resulting from projected fiscal deficits over the next decade. According to CBO projections, it is expected that the government debt held by the public will increase from 5.8 billion dollars in 2008 to 14.3 billion in 2019. As a result, U.S. public debt will represent 67.8% of GDP by the end of the decade.

Figure 1 - Public Debt of the U.S. 1939 - 2019²



Source: Department of the Treasury, CBO (2009)

At first glance these levels of indebtedness would appear to be unbearably high. Nevertheless, to place the CBO projections in an adequate context requires a historical perspective of the evolution of the U.S. public debt. As shown in Figure 1, the projected increase in public debt over the next decade is an unprecedented event in the postwar period both in terms of the pace of debt accumulation as well as in the amounts of

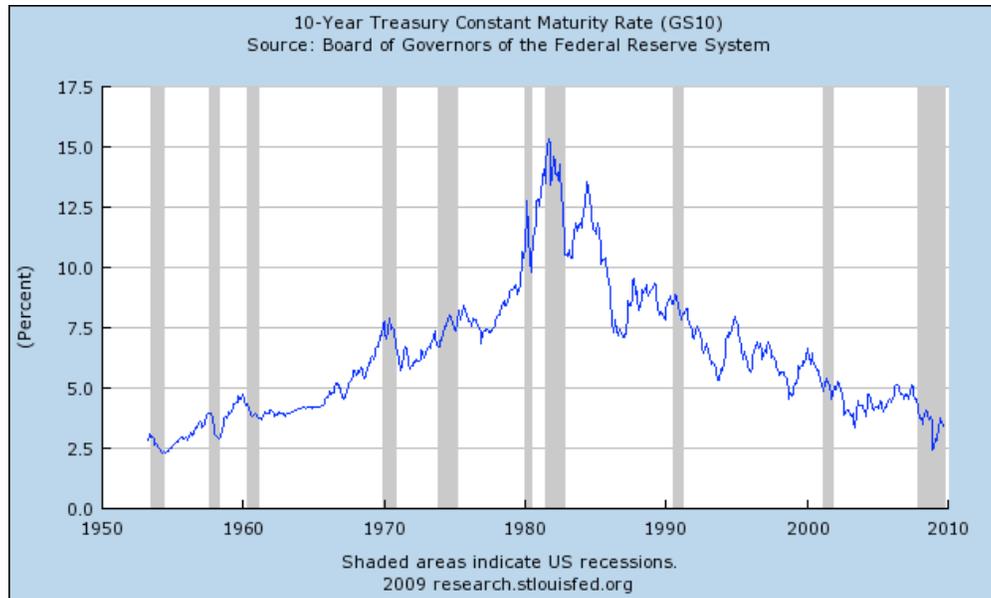
² Data for the 1939-2007 period was obtained from the U.S Department of Treasury. Data for the 2008 – 2019 period was obtained from the CBO official projections.

resources involved. Yet, the levels of indebtedness that are expected at the end of the following decade are still far from the peak of 108.6% of GDP reached in 1946. Is noteworthy then that this level of debt didn't represent a significant obstacle to the establishment of the political, economic and military hegemony of the U.S. in the West. Two factors help explain this apparent paradox.

First is the fact that while the U.S. gradually reduced the level of public debt as a percentage of GDP over the first 2 decades of war, this was achieved against a backdrop of increased public spending. As a result, debt in the hands of the public actually increased from 219 billion in 1950 to 237 billion in 1960. The key fact is that the U.S. never actually paid his debt. Thanks to a strong period of growth, the debt ratio to GDP was reduced and the fiscal situation significantly improved (Krugman 2009).

The second element was the will of the rest of the world to finance the U.S. over the postwar period. This willingness was based on three factors. The first is the perception among allied countries that the costs of failing to support the American global position outweigh the costs of maintaining that support. Second is the belief that American military power cannot be successfully defied. The third condition is that the financial system of the U.S. remains second to none as safe haven for the maintenance of liquidity and investment value³ (Galbraith and Munevar 2009).

Figure 2



Source: Federal Reserve Bank of St. Louis.

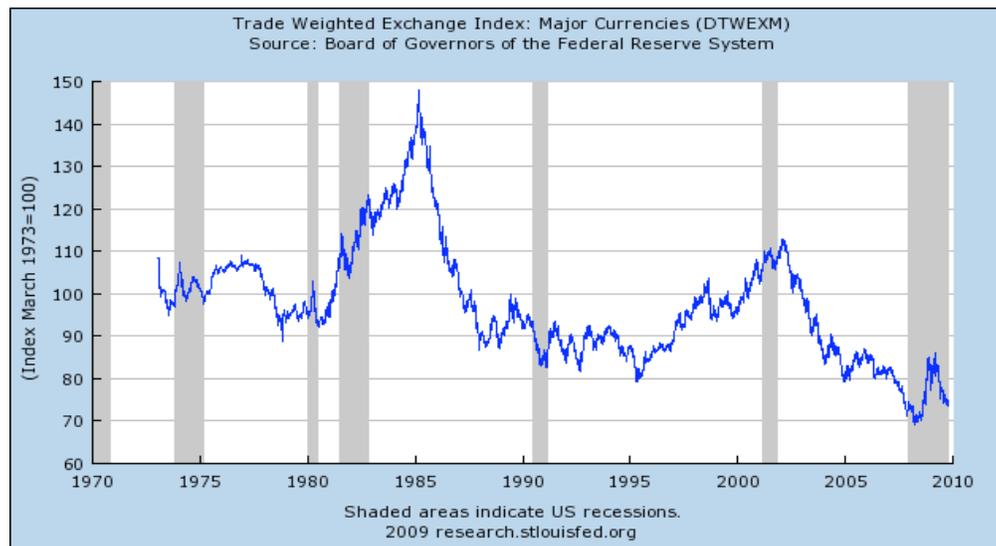
³ It is key to note that the conflicts in Iraq and Afghanistan have severely undermined the first two propositions.

This role of sanctuary in times of crisis of Treasury bonds is reflected in Figures 2 and 3. Figure 2 shows the yield of 10 year treasury bonds. This figure highlights that despite all the discussions and comments on the specialized press regarding the dire fiscal prospects of the U.S., today the country issues debt on extremely favorable terms compared to previous decades. As of October of 2009, rates averaged 3.30%⁴, equivalent to those observed in the late 50s.

Even more interesting is to note the significant drop of the yield in the moments of panic after the fall of Lehman Brothers. In the last third of 2008, the yield on the 3-month Treasury fell 153 points whereas the 10-year bond yield fell 149 points. The volatile behavior of markets during the crisis demonstrates that in the absence of viable alternatives, market participants invariably resort to U.S. Treasuries to protect themselves. This flight to quality is the key element that triggers the significant fall in the yields of treasury bonds.

The other facet of this dynamic is reflected in Chart 3, which shows the dollar exchange rate against the currencies of its major trading partners. The tendency towards depreciation of the U.S dollar during the last global economic cycle is abruptly interrupted to give way to a strong appreciation of 20.9% from the third quarter of 2008 to the first quarter of 2009. This dramatic shift took place to the extent that international investors reduced their risk exposure amid the crisis to return to the perceived safety of assets denominated in U.S. dollars.

Figure 3



Source: Federal Reserve Bank of St. Louis.

⁴ In the case of short term 3 month T-bills, the rates in October 2009 average 0.05. This is the lowest rate in history. In real terms, this implies negative returns for investors. See: <http://research.stlouisfed.org/fred2/series/DGS3MO?cid=115>

A skeptic might point out that as markets have returned to normal, the yield on Treasury bonds has gone up and the dollar has returned to its long-term trend towards depreciation. Even more important, the fact that up until today countries such as Japan and China have been willing to finance the U.S. deficit that does not imply that this will persist in the future.

Table 2 - Percentage of government bonds held by foreigners	
Country	%
U.S.	61.1
Japan	6.6
Germany	55.3
France	65.7
Italy	54
United Kingdom	36.3
Canada	14

Source: HSBC (2009)

Given the high percentage of U.S Treasuries in foreign hands, as shown in Table 2, it seems clear that the goodwill of both private investors and foreign central banks is a key element for the future financing of the U.S. fiscal deficit. More notably, given the high share of U.S. Treasury bonds in the portfolios of major central banks there is little incentive for a further increase in their exposure to U.S. dollar, as officials from China, India, Russia and Brazil have hinted in recent months.

Nevertheless, despite this grim picture there are elements that enable us to envision a scenario in which the expansion of the U.S. fiscal deficit over the next decade wont bring about an increase in interest rates or a massive outbreak of inflacion. To understand this apparent paradox, we need to analyze what happened in Japan in the period after the collapse of the financial bubble of the late '80s. This will be the subject of the second part of this article.

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