Is the US heading for a fiscal crisis?

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For Oxford Analytica, November 2003

This is a slightly longer article than appeared in Oxford Analytica. All views are mine and must not be taken to be those of Oxford Analytica

The worlds' balance sheet is looking decidedly lop-sided. These imbalances are more likely to lead to emerging market crises if the US suffers a fiscal crisis.

Multiple US liabilities – the ingredients for fiscal crisis

The US has made multiple implicit and contingent promises – showing up as balance-sheet liabilities:

Repayments to those who buy US debt

Huge capital inflows have allowed the US private and government sectors to run large deficits, helped to keep interest rates low, and supported stock prices. A pre-Bush fiscal surplus of 2.4% of GDP has become a deficit of 3.5%. Debt is largely being used to finance public and private consumption, rather than investment; under Bush, non-military discretionary public spending has risen by 21%, while investment as a proportion of GDP has fallen by 3%. A consumption-bubble can only be sustained if the economy can keep sucking finance in.

In part, the flows are a ripple effect form earlier crises, the surge in desired world reserves engendered, and the perception that the US is the 'safest' place to invest. It is very likely that such investment therefore does not price US debt correctly, and repayment will not be on the terms expected. Since the US won't default, the standard way to cut the payment would be some form of "inflation tax".

Social Security and Medicare benefits

Retiree numbers – the 'baby boom' generation – will rise dramatically in the next five to ten years. Social Security and Medicare benefits account for tens of billions of dollars of liabilities. These costs already dominate the Federal budget, with the administration eating into the Social Security and Medicare reserves. The shift from defined benefit to defined contribution pensions is creating further huge 'transition' liabilities.

Tax cuts

Formulated in the boom days of 1999, recent large tax cuts are not targeted at those with high marginal propensities to consume, and not designed principally to stimulate the economy. Worries – of people like Alan Greenspan – about the growing surplus at the end of the 1990s, propelled capital-based tax cuts onto the agenda, and political momentum drove them into the 2000's when they were less appropriate. Most of the recent tax cut has yet to go through (though consumers have responded to it, boosting consumption in the past quarter), so the impact on the deficit has only started to become apparent.

The mortgage market and real estate wealth

The mortgage market is linked to these other liabilities, since a rise in bond yields, consequent upon problems elsewhere in the balance sheet, weakens the re-mortgage market: Following an initial rise in yields, refinance deals fall, the duration of outstanding mortgages and mortgage-backed securities lengthens, and – given the wafer-thin safety margins of capitalisation – this requires continuous

hedging by the mortgage banks and holders of mortgage-backed securities. This collective behaviour reinforces the initial rise in yield – which feeds back to problems on other balance sheets. US government bonds bounced back in mid 2003 for this very reason.

In a crisis, markets may not be deep enough to absorb such continuous hedging, putting severe pressure on lenders (and borrowers). At the very least, market volatility would increase, mortgage bank profit margins fall, and interest rates rise even further. If, as is probably the case, there is a bubble element in US real estate (especially in coastal cities and large metropolitan areas), values would fall. This would generate yet more feedback effect. Since consumer spending is significantly more dependent on housing than equity wealth, this would also risk kicking away the main private-sector support for the US economy since the collapse of the 1990's stockmarket bubble.

In a worst-case scenario, it may not be possible to meet the implicit liability contained in the promise to bail out the US mortgage industry. The "too big to fail" argument only works if the government is able to take further liabilities onto its balance sheet. The knowledge that this may not be the case would itself help feed an incipient crisis.

US State deficits, the cost of Iraq, and equity wealth

To these liabilities can be added the liabilities of the US States – many suffering large deficits from the 1990s – that are legally obliged to balance their books (and might yet require Federal bail-outs), and the uncertain, and possibly large, liabilities related to Iraq and the "war on terror".

In addition, like so many other aspects of the US economy, share prices are in a 'bootstrap' equilibrium, in part pulled up by the debt-induced growth. In a fiscal crisis, share prices would not have their own fundamentals to hold themselves up. Loss in equity wealth would further depress private-sector consumption.

Adjustment will be needed eventually

At some point the combined savings rate of US households and corporations will have to rise to close the external deficit. Ending the recirculation of reserves, particularly from Asia, to US Treasury markets will cause a shift upwards in long-term US interest rates. This is inevitable. The question is whether it will be sooner and smoother, or later and stark.

A self-fulfilling crisis?

The starker possibility is that – without sufficient sustained growth – at some point, financial market fears regarding the inability of the US to resolve the inconsistency of all these promises without inflating the problem away, will precipitate higher real interest rates. After all, one of the supposed virtues of the current monetary framework is that interest rate policy is geared to rise in the face of even modest inflationary pressures. As the debt situation deteriorates and fears rise that the only route left is to inflate, interest rates have to rise. But this feeds the original debt problem, making it worse, feeding even higher interest rates. A self-fulfilling fiscal crisis is generated that spreads along lines of pre-existing emerging market weakness.

Experience and theory teach us that we never have to wait till the conditions of crisis are actually met in real time; markets always work (by backwards induction on the crisis) to bring a crisis forward to the *first* moment in time at which it is realised that there will be a crisis at *some* moment in time. Many of the imbalances are bubble-like and stable so long as the bubble is growing and self-justifying itself, only becoming unstable once the system stops expanding. Similarly, given the 'bubble' nature of many elements of the story, this allows for matters to drag on – in a state of false-security – until the conditions for crisis are met. In highly open capital markets, soft landings are difficult to pilot.

Poor accounting practices – of the government this time

Many of the liabilities are poorly quantified – exacerbating, and possibly concealing, the timing of crisis. To keep within Congress budget rules, the tax cuts are artificially presumed to be reversed, and spending projections are based on inflation rather than the recent, or even planned, rates of growth. Important elements, like the cost of reforming the Alternative Minimum Tax, are excluded. Under-reporting of liabilities runs to at least $5 trillion over the next decade. And this is an under-estimate since it ignores the less quantifiable contingent liabilities. This is happening at a time when policy makers are supposed to have learned lessons from the poor accounting practices of private corporations in the 1990s.

The global security significance of US debt

US debt levels have serious strategic implications with an administration intent on using military means to reshape the world. US military spending has risen by 27% in real terms under Bush. A sudden fiscal crisis might force an inopportune rethink of military strategy, just at the moment when the strategy was getting more demanding and costly before (supposedly) easing off. This would be tantamount to adding a "liquidity crisis" in global security, to the liquidity crises taking place on other parts of the balance sheet. Military adventure at a time of fiscal imbalance is not without risk.

Global weakness without US growth

Strong US growth was a major factor in getting over the Mexican peso and South-East Asian crises. A US-precipitated emerging market crisis would be worse with the backdrop of a weak US economy. EME currency appreciation would further slow growth and risk deflation in emerging markets. This would be compounded if Congress were to push through protectionist measures.

The dollar and interest rates

A fiscal crisis would be accompanied by a decline in the dollar – an obvious way to reduce liabilities (in effect a form of default). At some critical point, fears that this will happen will itself drive it to happen. Memories are short; from 1984 to 1987 the dollar suffered such a crisis.

Current imbalances may also be a function of interest rate illusion, of a world overreacting to historically low nominal interest rates. Indicative of this, real long-term interest rates recently rose on account of three, self-fulfilling, inefficiencies: the unwinding of carry trades; herd behaviour; and the hedging practices of mortgage banks – all three compounding each other. The lessons are that interest rates for borrowers can be higher at least in part for reasons not strictly related to inflation, and that central bank interest rate policy can lose its power to bail out consumers in times of crisis (and knowledge of this fact, helps the crisis along). While current long-term interest rates may seem high given inflationary expectations, they may turn out to be low compared to what materialises in a fiscal crisis.

Timing

US fiscal crisis will likely be avoided before the next US presidential election. There will be ways to push the reckoning off, and excess capacity will help to keep interest rates low for a while. Eventually, however, falls in the current account deficit and the capital account surplus will have to materialise and government debts will have to be reduced. And this *will* lead to higher interest rates. In the long run, inflating away the debt may well be the "easy" way to avoid the political pain of tax increases and budget cuts. With government, consumer, and corporate balance sheets overly-dependent on low rates, this will not be easy to stomach. To avoid political pain, it's good reason to put it off, even if it means

even higher interest rates after the election. The danger is that financial markets will work this out sooner than expected.