For release on delivery
12:15 pm EDT
September 13, 1995

Sound Public Finance as an International Public Good

Remarks by

Lawrence B. Lindsey

to the

Carnegie Mellon Global Outlook Conference

Pittsburgh, Pennsylvania

September 13, 1995

Sound Public Finance as an International Public Good

Thank you. It is my pleasure to be here today, and I am deeply honored to have been invited back. You see, central bankers are such a dreary and depressing lot that we rarely get return invitations. Usually we cast such a pall on whatever gathering we attend that the sponsors are lucky to be able to put on a similar event the next year, and few are brave enough to make the same mistake twice.

But, given the turnout today, last year's event must have been a success in spite of having a central banker around. So, I reread my speech of last year looking for some glimmer of hope, some ray of sunshine that I might have inadvertently shed. I found none. It was the usual gloom and doom. Then I looked at the list of attendees -- many of you are bond and currency traders, or their economic advisers. My questions about why I was invited back were answered. No other group could possibly be such gluttons for a depressing economic analysis.

You can witness this each month when the employment report comes out. Whenever there are numbers that to any ordinary mortal seem good -- more jobs at higher pay, for example -- it is inevitably called a "bad" report in the bond market. Bond market euphoria, on the other hand, seems to coincide with an increase in human misery. We central bankers may have the responsibility of taking away the punch bowl before the party really gets going, but at least we know a good party when we see it.

Last year my focus was on the public good aspects of smooth international economic relations. I argued that we were entering a phase in the international political cycle when it would become increasingly rare to find national leaders willing to make the domestic political

sacrifices necessary to pay the price for smooth international economic affairs. The result, I argued, would be an increased level of risk in international currency markets as the chances for miscalculation and resulting trade wars were enhanced.

One reason for my particular pessimism last year was that it was an election year in just about every major country. Nothing raises the discount rate of politicians -- their unwillingness to make short run political sacrifices for the long term good -- more than the advent of an election. However, getting those elections out of the way does not seem to have "cleared the air". Instead, the resolution of last year's elections has increased the focus on the next round of voting or on the complexities of coalition building.

This is certainly the case in Japan where political uncertainty remains in the headlines. Although the next Prime Minister is likely to be Mr. Hashimoto of the LDP, the traditional dominance of the Liberal Democrats seems to have ended. It is far from clear what type of politics will come in its place. In the interim, the normally decisive Japanese bureaucracy seems unusually inactive given the magnitude of the policy decisions which must be made. In Europe, the German election produced one of the closest results in the Federal Republic's history with the government's tenure potentially resting on the internal troubles of the junior coalition partner. The normally decisive policy result of a French presidential election seems to be missing this time, with a change in important ministers occurring unusually soon after the new government took office. The British Conservatives resolved their intraparty dispute by retaining the Prime Minister. Perhaps the ultimate in the political process was experienced by Italy, where the Parliament turned to that most nonpolitical of political animals -- a central banker -- to lead the government and get a budget through.

In the U.S., last year's elections seemed decisive enough, but the resulting path for the country is still left indeterminate by divided government. Again, the focus seems to be on the result of the next election. Campaigning for President began earlier than I can ever remember, a full two years before the Presidential election. Meanwhile, next year's Congressional elections will determine whether the 1994 result was a fluke, or truly indicative of a new direction for the country. It is almost as if the country decided that it has a big decision to make but wants to spend these two years hearing out both sides before finally committing to a particular path.

The relative indecisiveness of the political process around the world is not the result of an absence of decisions to be made. Indeed, the governments of the developed world not only share a sense of political drift, they also share a potentially tragic decline in the state of their public finances. In a number of instances -- Canada, Italy, and Sweden -- the deterioration in public finances was sufficiently severe as to become the determining factor driving their currencies on world markets. In each of those countries gross public debt was equal to or exceeded the nation's GDP. In such instances, it is easy to see how monetary policy can become encumbered by a nation's fiscal problems. With a debt equal to GDP, each 100 basis point rise in interest rates raises the nation's budget deficit by a full percentage point of GDP. But one need not limit concern about a nation's public finances to these instances of extreme short term problems. Nor should concern be primarily focussed on the present state of a country's budget. Rather, an analysis of the longer term budgetary implications of present policies provides the best guide to the challenges that lie ahead. Particularly striking is the present value of unfunded public pension liabilities --

legislatively promised future payments in excess of legislatively promised future taxes plus accrued pension assets.

In the United States we are justifiably concerned about unfunded pension liabilities in our Social Security system equal to a bit less than half of GDP in present value terms. According to an OECD study of international pension situations in 1990, the supposedly frugal Germans have an unfunded liability present value equal to 160 percent of GDP, the Japanese have unfunded liabilities equal to twice GDP in present value terms. In Canada, unfunded liabilities are 2.5 times GDP.

Furthermore, in spite of our problems in the U.S., we have at least designed the system so that future generations are not going to be getting an unsustainably good deal, but are instead going to see some of their contributions pay off a fraction of the unsustainably good deal that past generations have voted themselves. According to the OECD, prospective contributions exceed incremental future claims in the U.S. by about half of GDP. In Germany, by contrast, future contributions just about equal, in present value terms, incremental future benefits. There is no excess of future contributions over future incremental pension rights to cover the completely unfunded accrued rights earned by workers to date. Even worse, in Japan future contributions will not even cover future pension rights, let alone already accrued pension rights -- with a shortfall of 56 percent of GDP of future rights over future payments.

From the perspective of political economy, this is a very serious problem. In the United States, we have at least told the younger generation that it is not going to get a windfall out of Social Security. Former CEA Chairman Michael Boskin has estimated that

the average retiree in 1980 received a net wealth transfer from the Social Security system of $63,000. By contrast, a worker born in 1960 will suffer a net wealth loss of $48,000. In spite of this negative wealth transfer, we still have a system that is $2.5 trillion short. But, Germany has yet to get this message out to its young workers and the Japanese are still promising windfall benefits to the young. Unless voters in these countries are radically different than they are in America, the political problems they will have in reining in these costs will make ours seem relatively mild.

I think that the realities of these long run and deep seated fiscal problems are now gaining dramatically increased attention on world markets. With such huge unfunded pension shortfalls looming in the not too distant future, you do not have to be an Italy or a Sweden to have your government's fiscal attitude closely scrutinized. For, with these cascading liabilities, if a government's debt to GDP ratio is not yet at Italian levels, it will be in the foreseeable future. Thus, the numbers suggest that fiscal policy actions will increasingly drive foreign exchange markets in the years ahead.

There is already a substantial amount of debate underway about how fiscal policy actions affect the exchange rate. The standard textbook story suggests that a higher deficit will raise domestic interest rates thus increasing the demand for the country's capital assets. This causes a higher exchange rate as foreigners must purchase the nation's currency in order to purchase the nation's assets. The resulting capital inflow helps to finance some of the increased government deficit. In turn, with an expanding surplus on the capital account, the country must experience an increased current account deficit. This is facilitated by the higher exchange rate which makes exports less competitive abroad and imports more

competitive domestically. Thus, in the textbook story, a nation embarking on a credible long run deficit reduction strategy should witness a decline in the exchange value of its currency.

Yet, this textbook prediction has not always held true in practice. Most recently, Canada, Italy, and Sweden have each embarked on long term deficit reduction programs. In each case, the national currency seemed to rally on the news. In the United States, the decline in the value of the dollar early this year seemed to correspond to media focus on the tax cutting proposals being advanced in the new Congress. Later this year, as focus shifted to spending reduction and a long term deficit reduction strategy, the dollar seemed to rally. To the lay individual, it certainly seems plausible that a country with sound long term public finances should have a sounder currency, other things equal, than one with unsound public finances.

The key phrase is "other things equal". The question becomes whether or not the holders of government debt are compensated for any risks attendant to the quality of the nation's public finances. One of the most obvious risks involves inflation expectations. While it is certainly clear that government debt need not be monetized and that deficits need not be inflationary, there are sound reasons for believing that the political attractiveness of inflation rises as the nation's fiscal position deteriorates. Thus, holders of debt instruments might demand higher real returns in order to be compensated for the increased inflation risk. This higher real rate is over and above any increase in real interest rates caused by the short term macroeconomic effects of government deficits.

If one expects that markets work well at compensating for these risks, then there would be no reason to question the textbook story. But, there might be reasons why markets

might not work perfectly at risk compensation. Let us consider two types of decision maker behavior which might lead to such a result.

The first involves the response of monetary policy decision makers to the potential for a political decision to default on the public debt. I should note that the term "default" includes not only the technical legal sense of the term, but also (and more probably) a sudden rapid inflation designed to reduce the real burden of the debt. If the markets perceived that such a risk existed then it might be expected to be incorporated in the form of a higher real interest rate government debt. Presumably the real interest rate premium for default risk would vary over the term structure of the debt based on the perceived likelihood of default at any given time.

Now, let's imagine that the political authorities take actions which undermine the public finances of the country by increasing the deficit. The monetary authority knows from its historically based economic models how much the higher deficit should increase real interest rates. An appropriate response might involve raising nominal rates by that same amount to pass the expected increase in real rates through to the market.

But, the monetary authorities might not perceive the market's desire for an extra premium to compensate for the higher risk of default inherent in the new fiscal policy. Indeed, to even acknowledge such a default risk seems inappropriate for a central banker, who for the sake of credibility must act as if the risk of default on the only assets in his or her portfolio is zero. In this case, real interest rates might rise, but not enough to satisfy the market. The demand for the country's debt would therefore fall, the capital account surplus shrink, and the exchange value of the currency decline.

This process would also lead to a reduction in domestic demand. As domestic debt instruments were dumped in favor of foreign assets, more than 100 percent of the increase in the government debt would have to be financed out of domestic saving. This more-than-dollar-for-dollar crowding out of domestic investment would induce a domestic recession, lowering the ex-post real rate until it reached the rate perceived as appropriate by the monetary authorities. The price of increased default risk would be paid by lower levels of equilibrium income.

It is also easy to see how such a policy calamity could become self-reinforcing. The decline in domestic demand would, if anything, make the monetary authorities even more reluctant to raise rates enough to cover the default risk. Similarly, it would make the fiscal situation even worse as automatic fiscal stabilizers acted to reduce tax revenue and increase countercyclical spending. Both of these actions might easily be interpreted by the markets as contributing even further to default risk. Uninterrupted, this process cycles ever downward into an actual default.

This case describes a typical capital flight scenario not unlike that which is frequently associated with Latin America. For example, the recent Mexican situation has been attributable to an overly expansionary fiscal policy timed to coincide with the national elections. Ex post, it is clear that the Mexican monetary authorities did not raise rates sufficiently to accommodate for market perceptions of risk. Holders of pesos fled to dollars. The end result was a sudden 50 percent decline in the foreign exchange value of the peso. But the similarities of this case are not limited to Mexico. The recent currency crises in Sweden, Italy, and Canada were ended only when the fiscal authorities took action to

establish more credible states of public finance.

There are, however, some important limitations to the above scenario. Most important, the risk of default must be perceptible during the time horizon over which the monetary authorities can influence interest rates. If, for example, we knew that default could not happen until after a national election which is several years away, the kind of monetary policy miscalculation described above would be unlikely to matter since the default risk built into short term interest rates would be negligible. Thus, in all three of the developed economies mentioned above, debt was already roughly 100 percent of GDP or more. In addition, perceived default risk was probably enhanced in both Canada and Italy by the success of political movements favoring constitutional changes ending the supremacy of the central government.

However, these conditions do not describe the situation in the United States. Though our long term fiscal position may be far from strong, it is unlikely in the extreme that an actual debt repudiation, or its monetary equivalent, is even imaginable within the time horizon over which the monetary authorities influence interest rates. Why then has the dollar seemed to move with changes in the American fiscal outlook? This brings us to our second set of conditions in which markets may not fully be able to price in risks.

Implicit in an international debt obligation is repayment not just in currency, but in currency which is freely convertible into internationally traded goods and services at market determined prices. International capital markets must assume that reasonably fair rules of the game will continue to apply over the time horizon of the debt obligation both in the treatment of international capital and in the treatment of internationally traded goods. Should the rules

of international economic relations be altered by the borrower in a unilateral fashion between the time the debt is issued and the time it is repaid, the practical effect is a partial repudiation of the debt held by foreigners. In contrast to the case described above, this need not involve a direct change in the domestic price level, so domestic bond holders might be unaffected. We will call this case the internationally discriminatory scenario.

This internationally discriminatory scenario can take many forms. In the simplest case, let's imagine that we have some combination of government officials talking down the value of the currency while the central bank engages in sterilized intervention in the currency markets to reinforce the rhetoric. If this occurred prior to a repayment of debt held by foreigners, foreign holders would receive less than they anticipated in terms of their own currency. The debt holders' foreign exchange loss would, at least in part, be a profit made by the borrowing country's central bank in its sterilized foreign exchange dealings.

Alternatively, international discrimination might occur more directly through changes in tax legislation, tariffs, or the protection of internationally owned property. To varying degrees, these changes in national legislation might be adopted for reasons which putatively have nothing to do with debt repudiation. Consider, for example, a withholding tax on interest payments to foreigners. This has been considered both by the United States and by Germany, with predictable short-term effects on foreign currency values. This change in the rules of the game at the very least affects the present value of interest payments to foreigners, even those who comply fully with national tax laws. Coupled with the foreign exchange effect, the capital risk might be substantial. Other, more explicit changes in the rules of the game are also possible. Limitations could be placed on transfers of capital

outside of the country, for example.

Clearly any extreme measures which would adversely affect foreign bond holders would not be taken lightly by any government. But, if one rephrases the question to be, under what types of situations would such measures be possible, the development of high fiscal policy exposure to foreign debt holders would certainly be high on the list. Nations which develop weak fiscal positions and become indebted to foreigners as a result therefore have a particular obligation to avoid inflammatory rhetoric in the trade and international economic arenas and to avoid giving the appearance of talking down the value of their currency.

It would also seem logical that nations which have developed an international fiscal exposure and are perceived as having a high potential to inflammatory political rhetoric which blames foreigners for economic problems will, other things equal, see the exchange value of their currency tend to move in concert with their fiscal prospects. International investors will be likely to use the nation's long term fiscal situation as a factor in assessing the seriousness with which to take the political rhetoric. One would also assume that the political market for such rhetoric also rises with the seriousness of fiscal decisions. On net, therefore, a movement to fiscal soundness should act as a stabilizing force for currency markets around the world, making any destabilizing relationship between fiscal policy and currency movements less forceful. This is one important reason why sound fiscal policies have an international public good aspect.

There is another aspect to this international stabilization issue. Whether a fiscal deterioration raises or lowers the value of a currency does not have a symmetric effect on the

state of the international economy. In the textbook case in which a currency appreciates when a deficit worsens, the corresponding capital flow helps to stabilize both the domestic and the international economy. Capital flows to countries in which it earns the highest return, thus maximizing the world wide return to capital. By contrast, capital flight scenarios are inherently destabilizing and produce a lower world wide return to capital than would be the case in their absence. Thus, for any given degree of fiscal policy change, or for any given degree of political rhetoric, the better the nation's fiscal position, the less will be the potentially adverse consequences. Sound public finances are thus an international public good because they help insulate foreign exchange markets from politically induced destabilizing movements.

There is another aspect in which domestic public finance decisions might be an international public good. A move toward greater fiscal restraint is probably sound advice to the vast majority of the countries in the world given that the real return to private investment exceeds the return on government spending. Yet, elected politicians are often loathe to engage in such sound practices. As noted earlier, the discount rate used by a politician might well be influenced by the timing of the next election. This election is probably due before the usual payback period on either public or private capital, thus leading the politician to be more willing to borrow for vote enhancing projects than simple economics might consider justified. One might presume that such logic can be imputed to elected politicians around the globe.

Offsetting this is what one might consider the "role model" effect. If some politician somewhere chooses to adopt policies with a longer term view than the next election, and

survives at the polls, then his or her country might come to benefit from the long term benefits of sound public finance policies. Gradually, that country comes to be viewed as an international economic success. Politicians in other countries might take heart, and adopt policies which they otherwise would consider excessively courageous or far sighted.

This "role model" effect is nothing novel. During the Cold War, for example, domestic economic policies and national projects were often justified by the need to convince emerging nations of the superiority of our system. More recently, Margaret Thatcher's deregulatory successes in Britain were held up as an international example by those seeking to liberalize their own countries. Similarly, the labor market policies of Germany and the bureaucratic guidance of Japan's MITI were, until recently, cited by many in this country of examples to be followed.

Perhaps what the industrialized world needs is a government which is able to dramatically improve the quality of its public finance position, particularly its long term situation, and survive at the polls. Pension and health entitlements for the elderly are no doubt the proverbial third rail of politics, not only in this country, but around the world. Should any government successfully tackle these untouchable political issues, it would not only reap benefits for the economy over which it presides, it might provide courage for political leaders in other countries, as well.

There is at least one good reason to expect that America could be the country to provide this international public good. As I noted earlier, our unfunded pension and health obligations are a smaller proportion of our GDP than those of any other industrialized country. By definition, they are therefore the most manageable. Also, as I noted earlier,

there is probably a larger constituency in this country for reform than elsewhere, due to both enhanced public awareness of the issue and the existence of demographic groups which are "losers" under the status quo.

At present, the Congress has begun to make some timid first steps in this regard. I want to stress that, from the perspective of providing an international public good, their actions must be characterized as timid first steps even though they represent very radical, even revolutionary, ideas when placed in the political context. Unfunded Social Security liabilities remain off the table for discussion. The level of the deficit is cut by less than one half of one percent of GDP per year, though because the deficit would have automatically risen in the absence of action, the level of legislated prospective spending reduction is closer to 0.7 percent of GDP per year.

Still, the political opposition to such cuts is enormous. Many politicians and interest groups deny even that there is a long term problem with the current level of health care and pension commitments. Others suggest that only modest changes are needed and that with modest changes in economic forecasting assumptions public finances can be put on a sound footing. Frankly, I remember similar arguments being made during the 1980s. If we rely on everything breaking just right, we are sure to be disappointed.

In any event, we will know in the next eight weeks whether our system is going to produce the kind of first steps which are needed to proceed on the road to sound public finances, or whether we won't. Frankly, I think that if America is not going to take those steps this year, it is unlikely that we will be the international role model which I described above. Furthermore, the legislative agenda this year will have to be followed by still further

actions, particularly on Social Security, in the years ahead. To make matters more complicated, even if our legislative and executive branches begin the process of solving our government's financial problems, their decision is still subject to de facto ratification by the voters.

But if we succeed in getting our fiscal house in order, not only our economy, but that of the world will be the better for it. Sound public finance in America has worldwide ramifications. Not least of these will be a more stable and settled set of international exchange rates and a reduced likelihood of destabilizing currency movements. Over the next few years, with any luck, our political leaders will find it in their interest to act for the international public good. If they do, we should make sure they get some of the credit.