Fiscal expansions in submerging markets; the case of the USA and the UK.

Willem Buiter

FT Maverecon, February 5, 2009

Fiscal expansions in submerging markets; the case of the USA and the UK February 5, 2009 1:07am On a number of occasions I have cautioned against deficit-financed fiscal stimuli in countries whose governments have weak fiscal credibility, that is, countries where current tax cuts or public spending increases cannot be credibly matched by commitments to future public spending cuts and tax increases of equal present discounted value. I believe that both the US and the UK fall into this category.

I have spent a good part of my career as a professional economist working on developing countries and emerging markets - in South America, in Central and Eastern Europe and the former Soviet Union and in Asia. Increasingly, I find it helpful to analyse the crises afflicting the US and the UK as emerging market crises - perhaps they could be called submerging markets crises.

During the decade leading up to the crisis, current account deficits increased steadily and became unsustainable. Strong domestic investment (much of it in unproductive residential construction) outstripped domestic saving. Government budget discipline dissipated; fiscal policy became pro-cyclical. Financial regulation and supervision was weak to non-existent, encouraging credit and asset price booms and bubbles. Corporate governance, especially but not only in the banking sector, became increasingly subservient to the interests of the CEOs and the other top managers. There was a steady erosion in business ethics and moral standards in commerce and trade. Regulatory capture and corruption, from petty corruption to grand corruption to state capture, became common place. Truth-telling and trust became increasingly scarce commodities in politics and in business life. The choice between telling the truth (the whole truth and nothing but the truth) and telling a deliberate lie or half-truth became a tactical option. Combined with increasing myopia, this meant that even reputational considerations no longer acted as a constraint on deliberate deception and the use of lies as a policy instrument.

As part of this widespread erosion of social capital, both citizens and markets lost faith in the ability of governments to commit themselves to any future course of action that was not validated, at each future point in time, as the most opportunistic course of action at that future point in time - what macroeconomists call time-consistent policies and game theorists call subgame-perfect strategies.

This morality tale has important consequences for a governments ability to conduct effective countercyclical policy. For a fiscal stimulus (current tax cut or public spending increase) to boost demand, it is necessary that the markets and the public at large believe that sooner or later, measures will be taken to reverse the tax cut or spending increase in present value terms. If markets and the public at large no longer believe that the authorities will assure fiscal sustainability by raising future taxes or cutting future public expenditure by the necessary amounts, they will conclude that the government plans either to permanently monetise the increased amounts of public debt resulting from the fiscal stimulus, or that it will default on its debt obligations. Permanent monetisation of the kind of government deficits anticipated for the next few years in the US and the UK would, sooner or later be highly inflationary. This would raise long-term nominal interest rates and probably give risk to inflation risk premia on public and private debt instruments as well. Default would build default risk premia into sovereign interest rates, and act as a break on demand.

Because I believe that neither the US nor the UK authorities have the political credibility to commit themselves to future tax increases and public spending cuts commensurate with the up-front tax cuts and spending increases they are contemplating, I believe that neither the US nor the UK should engage in any significant discretionary cyclical fiscal stimulus, whether through higher public spending (consumption or investment) or through tax cuts or increased transfer payments.

Instead, the US and UK fiscal authorities should aggressively use their fiscal resources to support quantitative easing and credit easing by the Fed and by the Bank of England (through indemnities offered by the respective Treasuries to the Fed and the Bank of England to cover the credit risk on the private securities these central banks have purchased and are about to purchase). The £50 bn indemnity granted the Bank of England for its Asset Purchase Facility, by HM Treasury should be viewed as just the first installment on a much larger indemnity that could easily reach £300 bn or £500 bn. The rest of the scarce, credibility-constrained fiscal resources of the US and the UK should be focused on recapitalising the banking system with a view to supporting new lending by these banks, rather than on underwriting existing assets or existing creditors. Other available fiscal resources should be focused on supporting, through guarantees and insurance-type arrangements, flows of new lending and borrowing. As regards recapitalisation and dealing with toxic assets I either favour temporary comprehensive nationalisation or the good bank model. Existing private shareholders of the banks, and existing creditors and holders of unsecured debt (junior or senior) should be left to sink or swim without any further fiscal support, as soon as new lending, investment and borrowing has been concentrated in new, state-owned good banks.

It is true that, despite the increase in longer-term Treasury yields from the extreme lows of early December 2008, recent observations on government bond yields dont indicate any major US Treasury debt aversion, either through an increase in nominal or real longer-term risk-free rates or through increases in default risk premia although it is true that even US Treasury CDS rates have risen recently to levels that, although low by international standards, are historically unprecedented.

In a world where all securities, private and public, are mistrusted, the US sovereign debt is, for the moment, mistrusted less than almost all other financial instruments (Bunds are a possible exception). But as the recession deepens, and as discretionary fiscal measures in the US produce 12% to 14% of GDP general government financial deficits figures associated historically not even with most emerging markets, but just with the basket cases among them, and with banana republics I expect that US sovereign bond yields will begin to reflect expeted inflation premia (if the markets believe that the Fed will be forced to inflate the sovereigns way out of an unsustainable debt burden) or default risk premia.

The US is helped by the absence of original sin its ability to borrow abroad in securities denominated in its own currency and the closely related status of the US dollar as the worlds leading reserve currency. But this elastic cannot be stretched indefinitely. While it is hard to be scientifically precise about this, I believe that the anticipated future US Federal deficits and the growing contingent exposure of the US sovereign to its financial system (and to a growing list of other more or less deserving domestic industries and other good causes) will cause the dollar in a couple of years to look more like an emerging market currency than like the US dollar of old. The UK is already closer to that position than the US, because of the minor-league legacy reserve currency status of sterling.

Under conditions of high international capital mobility, non-monetised fiscal expansion strengthens the currency if the government has fiscal-financial credibility, that is, if the markets believe the expansion will in due cause be reversed and will not undermine the sustainability of the governments fiscal-financial-monetary programme. If the deficits are monetised, the effect on the currency is ambiguous in the short run (it is more likely to weaken the currency if markets are forward-looking), but negative in the medium and long term. If the increased deficits undermine the credibility of the sustainability of the fiscal programme, then the effect on the currency could be be negative immediately.

The only element of a classical emerging market crisis that is missing from the US and UK experiences since August 2007 is the sudden stop - the cessation of capital inflows to both the private and public sectors. There has been a partial sudden stop of financial flows, both domestic and external, to the banking sector and the rest of the private sector, but the external capital accounts are still functioning for the sovereigns and for the remaining creditworthy borrowers. But that should not be taken for granted, even for the US with its extra protection layer from the status of the US dollar as the worlds leading reserve currency. A large fiscal stimulus from a government without fiscal credibility could be the trigger for a sudden stop.

So just dont do it. Focus fiscal resources on getting the credit mechanism and other key parts of the financial intermediation process going again. Effective Keynesian fiscal policy requires a virtuous policy maker, capable of credible commitment - that is, commitment capable of resisting the future the siren calls of opportunistic reneging on past commitments. The Obama administration is new and has had but limited opportunity to abuse the trust placed in its promises and commitments. That puts it in a better position that the UK government, which has been in office since May 1997. But many of the top players in Obamas economic team are strongly identified with the failed policies, regulations and laws that brought us the disaster we are facing. So the amount of credibility capital is severely limited even for Obama. Use it to get credit flowing again. Tax cuts for friends and favoured constituencies, replacing clapped-out infrastructure and even the fight against global warming will have to wait until trust - public credit - is restored.