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Main Points

1) The United States needs to embark on a program of medium-term fiscal consolidation that will stabilize and, in the foreseeable future, bring down government debt relative to GDP.
2) The precise limit on debt relative to GDP for the United States is not known and hard to estimate precisely given the reserve currency status of the US dollar, the nature of alternative reserve assets (the euro, Swiss franc, Japanese yen, and British pound), and the high level of savings around the world that official and private sectors want to hold in foreign currency.
3) The best way to bring debt-GDP under control is to limit future spending increases and boost revenue while the economy continues to recover. In particular, health care spending needs to be credibly constrained. There is also a pressing need for tax reform – to reduce complexity, lower distortions, and in particular roll-back the subsidies for household and corporate debt that have crept into the system. Excessive private sector debts pose a significant systemic and fiscal risk to the economy.
4) Immediate spending cuts would, by themselves, likely slow the economy. The IMF's comprehensive recent review of cross-country evidence concludes: "A budget cut equal to 1 percent of GDP typically reduces domestic demand by about 1 percent and raises the unemployment rate by 0.3 percentage point."[2]
5) The contractionary effects of spending cuts can sometimes be offset by other changes in economic policy or conditions, but these are unlikely to apply in the United States today
    a. If there is high perceived sovereign default risk, fiscal contraction can potentially lower long-term interest rates. But the US is currently one the lowest perceived risk countries in the world – hence the widespread use of the US dollar as a reserve asset. To the extent there is pressure on long-term interest rates in the US today due to fiscal concerns, these are mostly about the longer-term issues involving healthcare spending; if this spending were to be credibly constrained (e.g., in plausible projections for 2030 or 2050), long rates should fall. In contrast, cutting discretionary spending would have little impact on the market assessment of our longer-term fiscal stability.

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[1] This testimony draws on joint work with Peter Boone and James Kwak. Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at http://BaselineScenario.com, where we also provide daily updates and detailed policy assessments for the global economy.

[2] *World Economic Outlook*, October 2010, Chapter 3, "Will It Hurt? Macroeconomic Effects of Fiscal Consolidation," p.113. This study has important methodological advantages, in particular because it focuses on policy intentions and attempts to implement spending cuts and revenue increases.

b. It is also highly unlikely that short-term spending cuts would directly boost confidence among households or firms in the current US situation, particularly with employment still around 5 percent below its pre-crisis level. The US still has a significant "output gap" between actual and potential GDP, so unemployment is significantly above the achievable rate. Fiscal contractions rarely inspire confidence in such a situation.

c. If monetary policy becomes more expansionary while fiscal policy contracts, this can offset to some degree the negative short-run effects of spending cuts on the economy. But in the US today, short-term interest rates are as low as they can be and the Federal Reserve has already engaged in a substantial amount of "quantitative easing" to bring down interest rates on longer-term debt. It is unclear that much more monetary policy expansion would be advisable or possible in the view of the Fed, even if unemployment increases again – for example because fiscal contraction involves laying off government workers.

d. Tighter fiscal policy and easier monetary policy can, in small open economies with flexible exchange rates, push down (depreciate) the relative value of the currency – thus increasing exports and making it easier for domestic producers to compete against imports. But this is unlikely to happen in the United States, in part because other industrialized countries are also undertaking fiscal policy contraction. Also, the preeminent reserve currency status of the dollar means that it rises and falls in response to world events outside our control – and at present political and economic instabilities elsewhere seem likely to keep the dollar relatively strong.

6) The available evidence, including international experience, suggests it is very unlikely that the United States could experience an "expansionary fiscal contraction" as a result of short-term cuts in discretionary federal government spending.

7) The advisable debt limit, relative to GDP, for the United States is subject to considerable debate and is not knowable with a high degree of precision. There is no precise debt-GDP level at which a crisis is triggered, but with debt relative to GDP in or above the range of 90-100 percent, a country becomes much more vulnerable to external shocks – particularly if it is relying on foreign investors to buy a substantial part of its debt.

8) If such a shock throws the economy into recession, fiscal policy in most industrialized countries will to some degree automatically counteract the effect – as spending increases (on unemployment benefits and other forms of social support) and taxation declines (as GDP falls). Such automatic stabilizers are generally helpful as they prevent the recession from becoming more serious – or even some form of prolonged collapse, which was the pre-1945 experience of many countries.

9) It is important not to oversimply fiscal concerns into precise cut-offs for "dangerous" debt levels. Recent European experience provides ample illustration that countries can run into trouble refinancing their debts at a wide range of debt-to-GDP values.

a. Greece ran into trouble in 2010 with gross debt relative to GDP of 142 percent; its debt levels in 2006 and 2007 were around 105 percent. This is a classic case of too much debt by any measure – although the full extent of the debt and underlying deficits were not completely clear until market perceptions shifted against Greece.

b. Portugal faces a fiscal crisis with gross debt at 90.6 percent of GDP in 2011, but its debt was only 62.7 percent in 2007. The issue for Portugal is low achieved and expected growth relative to fiscal deficits – the markets have become unwilling to support debt that continues to increase as a percent of GDP.

c. Ireland, the third eurozone country that currently has an IMF program, is a different kind of fiscal disaster. In this case, the on-balance sheet government debt was low (25 percent of GDP in 2006-07 for gross debt) but there was a big build up in off-balance sheet obligations – in the form of implicit support available to a banking system that was taking on large risks. Bailing out the banks in fall 2008 and supporting the economy during severe recession has pushed up gross debt to 114 percent of GDP in 2011 and debt levels will reach at least 125 percent (in our estimates, even higher) before stabilizing.

10) Within the set of industrialized countries, Japan stands out as an extreme. Government debt-relative to GDP is expected to reach 229.1 percent in 2011 (on a gross basis) and rise to 250.5 percent in 2016. On a net basis – taking out government debt held by other parts of the public sector – the equivalent figures are 127.8 percent in 2011 and 163.9 percent for 2016. But nearly 95 percent of Japanese government debt is held by residents – and, at least for the time being, Japanese household and business savings remain high. Countries with greater reliance on foreign savers, such as the US (where nonresidents held over 30 percent of general government debt in 2010) and the UK (nonresidents held 26.7 percent of general government debt in 2010) need to be much more careful. Within the eurozone, as a result of greater financial integration combined with the mispricing of risk, foreigners typically hold 40-90 percent of all outstanding government debt (mostly held by other eurozone financial institutions).

11) The increase in debt relative to GDP in industrialized countries from 2007 to 2011 was about 28 percent (of GDP; unweighted average across countries, as calculated by the IMF) – most of which was due to automatic stabilizers, i.e., the increase in spending and fall in taxation that occurs whenever a country goes into recession.

12) Seen in that context, the increase in the US gross debt – from 62.2 percent of GDP in 2006 to 91.6 percent at the end of 2010 – was very much in line with experience in other countries. But the current trajectory of debt now, rising to 111.9 percent in 2016, is on the high end (the average debt-GDP for industrialized countries is projected to rise by about 5 percent over this period.)

13) In terms of net general government debt held by the private sector, at the end of 2011, the US is expected to have around 72.4 percent of GDP – up from 42.6 in 2007. This is not yet at a dangerous level but the future projections are not encouraging – this number will rise to 85.7 percent in 2016, according to the IMF. And in the Congressional Budget Office's longer-term projections, the future costs of healthcare cause a rise in debt to Japanese levels or beyond by 2030 or 2050.

14) In addition, the United States continues to face very large implicit liabilities in the form of implicit support available to the financial sector, both directly – if "too big to fail" global banks get into trouble – and indirectly, in the form of automatic stabilizers that will always kick in when the economy declines sharply due to a banking crisis.

15) If a financial crisis due to the mispricing of risk causes a fiscal crisis, including immediate spending cuts and tax increases, this has major distributional consequences. The financial sector managers and traders who do well during a financial boom are highly paid; typically this is on a return-on-equity basis without appropriate adjustment for risk, so they take on too much debt. When the downside risks materialize, the costs of the crisis are borne by those who lose jobs and suffer other collateral damage. If sharp spending cuts follow that reduce public services (e.g., government-funded education), this effectively transfers the costs of dangerous compensation schemes for the financial elite onto the middle class and relatively poor people.

16) There is nothing pro-market or pro-private sector about an inefficient redistribution scheme that allows a few people to become richer due to implicit government subsidies for "too big to fail" global financial institutions. Such firms are likely to damage themselves with some regularity – their executives have little incentive to be sufficiently cautious. If the consequent crises undermine public goods, such as access to effective education and quality healthcare, this is likely to permanently lower growth rates through undermining the human capital of the US workforce.

17) The remainder of this testimony takes up the issue of how fast we should aim to make a fiscal adjustment in the United States.

Speed of Fiscal Adjustment: Three Scenarios

There is a growing consensus that the US faces some sort of fiscal crisis that will force an adjustment – implying some combination of lower spending and higher revenue. But there are at least three kinds of fiscal adjustment around the world today: those forced by the market, typically involving sharp spending cuts (e.g., Greece); those undertaken by governments trying to get ahead of the market, often placing greater weight on moderate tax increases (e.g., the UK); and those involving the need the control future spending on health care (almost all countries are in this boat to some degree). Where does the US fit in this comparison?

Greece

Greece, the UK, and the United States all had headline fiscal deficits around 10 percent of GDP in 2010. Their "general government balances", from the International Monetary Fund's latest *Fiscal Monitor* (http://www.imf.org/external/pubs/ft/fm/2011/01/pdf/fm1101.pdf, p.121), showed deficits of 9.6 percent of GDP, 10.4 percent, and 10.6 percent respectively. (This measure consolidates all levels of government; in a federal system, this can be misleading – but for the broad US budget picture these data are still a helpful).

Greece is in the midst of a very big fiscal adjustment. Its primary deficit – which measures the budget taking out interest payments, thus reflecting the underlying fiscal policy stance – moved from a deficit of 10.1 percent in 2009 to a deficit of 3.2 percent in 2010 and, according to the IMF (p.122), is on its way to a small primary surplus in 2012 (0.9 percent of GDP).[3] The Greeks were forced into this adjustment by the market being unwilling to continue to finance a string of

[3] The Greek program is currently being adjusted and renegotiated, so these numbers may change. But the scale and speed of fiscal adjustment will likely remain similar.

deficits – once the perception took hold that general government gross debt at 126.8 percent of GDP in 2009 and 142 percent in 2010 was simply not sustainable.

The Greek program, if it stays on track with IMF and EU support, is mostly about spending cuts relative to the size of the economy. Over 2009-2016, Greek general government expenditure is forecast to fall by more than 13 percent of GDP, from 53.2 percent to 39.6 percent of GDP (IMF, p.125). General government revenue, in contrast, will remain about the same – it was 37.8 percent in 2009 and will be 37.6 percent in 2016 (p.126). Whatever you think of whether Greece will continue to pay all its debts, in the IMF's baseline scenario, this kind of fiscal crisis leads to massive spending cuts.

United Kingdom

The UK is also making a significant fiscal adjustment from a primary balance that peaked at a deficit of 8.5 percent of GDP in 2009. The primary deficit is forecast at 5.5 percent of GDP in 2011, moving to a small primary surplus in 2015; its net debt, which does not count government debt held by other parts of the public sector, will not break 80 percent of GDP.

Despite the current rhetoric around austerity in the UK, this fiscal adjustment is actually more about increasing revenues. Over 2009-16, spending will rise slightly, from 36.8 percent of GDP in 2009 to 37.4 percent in 2016. Taxation will increase by more: it was 30.8 percent of GDP in 2009 and will be 35.4 percent in 2016.

United States

The US is still struggling to recover from a massive financial crisis, which directly reduced revenue and increased spending as employment fell sharply. The fiscal costs of banks blowing themselves up in this way are huge and the additional debt incurred will take a long time to pay off. Net general government debt will increase from 48.4 percent in 2008 to 85.7 percent in 2016.

But despite the devastating blow, the economy should return to potential output and much higher employment levels soon.

The right way to adjust for the recession and its aftermath is to look at the cyclically adjusted primary balance, i.e., what our fiscal policy stance would be if unemployment were back around 5 percent. In the US, this will move from a deficit of 2.7 percent in 2008 to a deficit of 1.6 percent of GDP in 2016. Assuming global savings continue to flow towards the United States, the short-term risks posed by this deficit level are manageable – as long as some responsible medium-term fiscal adjustment actually takes places.

US general government revenue is forecast to rise from 33.8 percent of GDP, where it was in 2006 and 2007, to 35.4 percent in 2016 – presumably the IMF expects the Bush tax cuts to be repealed at some point. US general government spending will rise from 36.6 percent of GDP in 2007 to 41.4 percent in 2016.

It's this future increase in spending that needs to be constrained in the United States. Most of this is not about discretionary spending, at least not about its domestic components – spending on overseas wars continues to be a significant issue. And not much is about pensions either; the IMF's projections of net present value of pension spending change over 40 years, 2010-50, are 23.5 percent of GDP, one of the lowest in the industrialized world.

But the US is definitely at the bad extreme of the charts when it comes to future health care spending. The net present value (NPV) of the change in health care spending, 2010-50, is 164.5 percent of GDP, the highest in the industrialized world (p.129). Among comparable countries, Sweden seems to have this under control at 11.7 percent. Greece and the UK have looming problems – NPV of 106.9 percent and 113.3 percent respectively – but most industrial countries have this number contained in the range of 30-80 percent of GDP (still, not good news for anyone).

US healthcare costs incurred by the government will increase by 5.1 percent of GDP between 2010 and 2030, according to the IMF projections (p.129). This is the clear and present danger – which is somehow lost in the rhetoric of the current fiscal debate.

There are three ways to deal with the real US fiscal crisis: ignore it, which would be a bad mistake; transfer rising health care costs off the government budget and onto individuals and firms, which would seriously impede private sector growth; or really find ways to limit future increases in health care costs.