Public or Private Finance?

Stephanie Kelton
Professor of Economics
University of Missouri-Kansas City
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The Orthodox Perspective

$$G + iB = T + \Delta B + \Delta M$$

Assumptions:

Gov't spending is "financed" by $T + \Delta B$

"Financing" gov't spending via ΔM is inflationary

"Constraint" is thus to select G such that $\Delta M = 0$

Intertemporal Budget Constraint

Blanchard et al. 1990

$\Delta B = G – T + iB$ (note no ΔM)

Rewriting in real terms and as % of real GDP:

$\Delta b = g - t + (r – \Theta)b$

For any time, n, in the future . . .

$b_N = b_0(1+r-\Theta)^N + \Sigma(g-t)(1+r-\Theta)^{N-k}$

Taking present value . . .

PV $b_N = b_0$ + PV projected $\Sigma(g-t)$

$$PV\ b_N = b_0 + PV \text{ projected } \Sigma(g-t)$$

And since: $PV\ b_N = b_N / (1+r-\Theta)^N$,

Then: $\text{Limit } PV\ b_N \text{ as } N \rightarrow \infty = 0$

Thus, for fiscal sustainability:

$$0 = b_0 + PV \text{ projected } \Sigma(g-t)$$

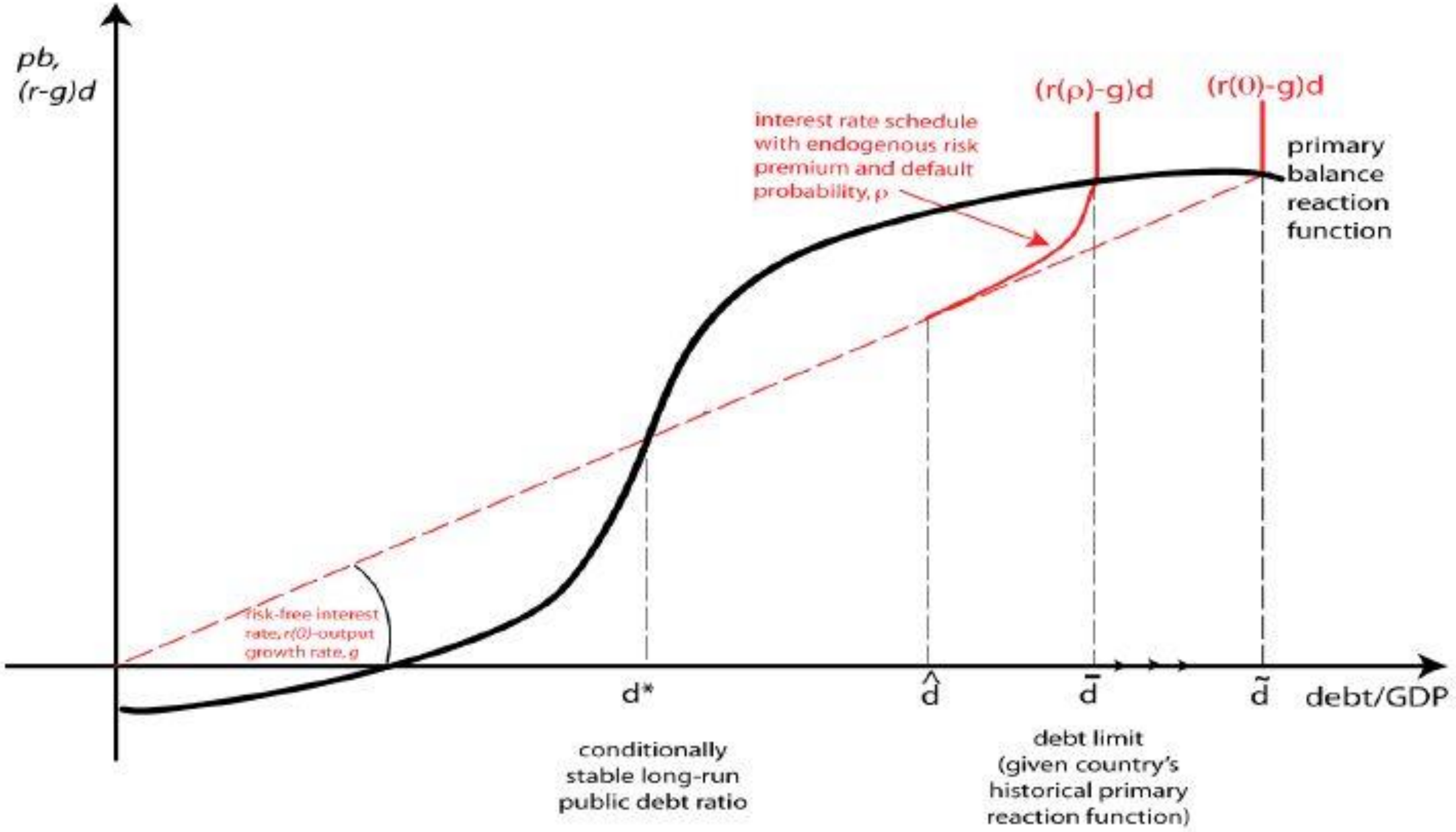
$$-b_0 = PV \text{ projected } \Sigma(g-t)$$

In (Other) Words

- The cumulative discounted present value of the expected future **surpluses** must be equal to the current national debt outstanding

- If that condition is not satisfied, then the government would have to eventually repudiate its debt, either by an outright default or through the use of inflation

Resulting in Something Like This



Fear of Unsustainable Public Debt

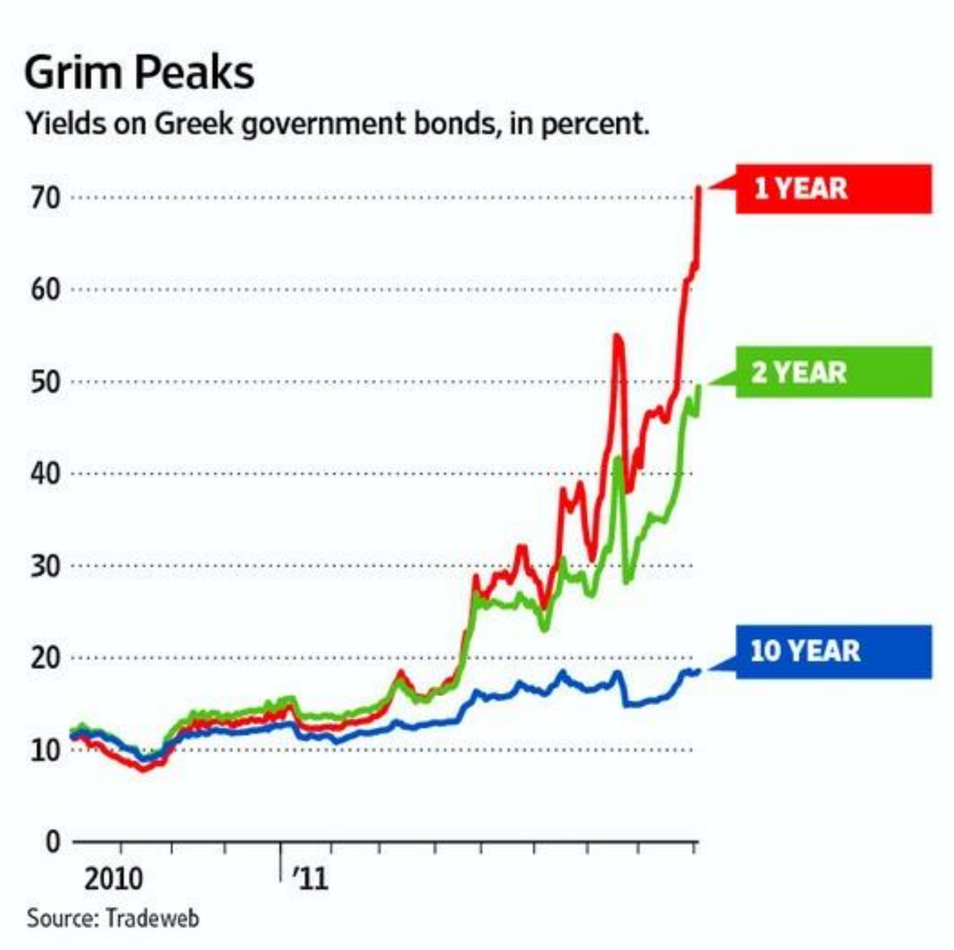
"California's bond rating has sunk to a level just above junk status . . . . California is teaching the U.S. a valuable lesson about the connection between fiscal policy and financial markets."

"Unless action is taken very soon to reform the main U.S. benefit programmes, Washington may have to grapple with the same crisis currently preoccupying Sacramento."

"Unresolved, the situation could cause U.S. Treasury yields to rise sharply, wreaking havoc on the national economy."

~Gokhale and Smetters, Financial Times (9/7/03)

Greece Became the Poster Child



What's Different About the US (or UK)?

- In a modern (or sovereign money) system operating **with flexible exchange rates**, interest rates on the national debt are a matter of political economy

- "This has significant implications for the appropriate 'mix' of monetary and fiscal policies, particularly if full employment and financial stability are considered fundamental goals of macroeconomic policy."

~ Scott Fullwiler, 2006

Fullwiler on "Fiscal Sustainability"

- "In short, the orthodox concept of fiscal sustainability is flawed due to its assumption that a key variable – the interest rate paid on the national debt – is set in private financial markets as in the orthodox loanable funds framework"

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Interest Rates and Fiscal Sustainability

Scott T. Fullwiler

Wartburg College; Bard College - The Levy Economics Institute

July 1, 2006

ver the future path of federal spending on entitlement programs grov
Kotlikoff 1992) have been particularly prominent here. These econor
magnitude of an existing unsustainable fiscal path. They argue that
etters 2003a). Others within the circle have noted the $44 trillion "fis
2003) and in other publications (e.g., Ferguson and Kotlikoff 2003; K
future GDP shows it to be about 7 percent (e.g., Auerbach et al. 200

An Alternative Perspective

The Financial Balance Approach To Fiscal Space and Financial Stability

- Understood by J.M. Keynes and early Keynesians like Nicholas Kaldor, Abba Lerner, and Joan Robinson

- "Lost in the headlong rush over the past three decades of mainstream macroeconomics to become a special branch of microeconomics, which itself appears to have become a special branch of applied calculus in some sort of rather twisted physics envy." (Parenteau, 2009)

Godley's Claim

"Without an expansionary fiscal policy, real output cannot grow for long."

~ Wynne Godley, 2000

Why?

- Because of persistent current account deficits

- Important implications for financial stability

- Godley relied on the sector balance framework to undertake his analyses

- Showed that countries with current account deficits would need to run budget deficits **most of the time**

Why Does it Have to be *Public* Finance?

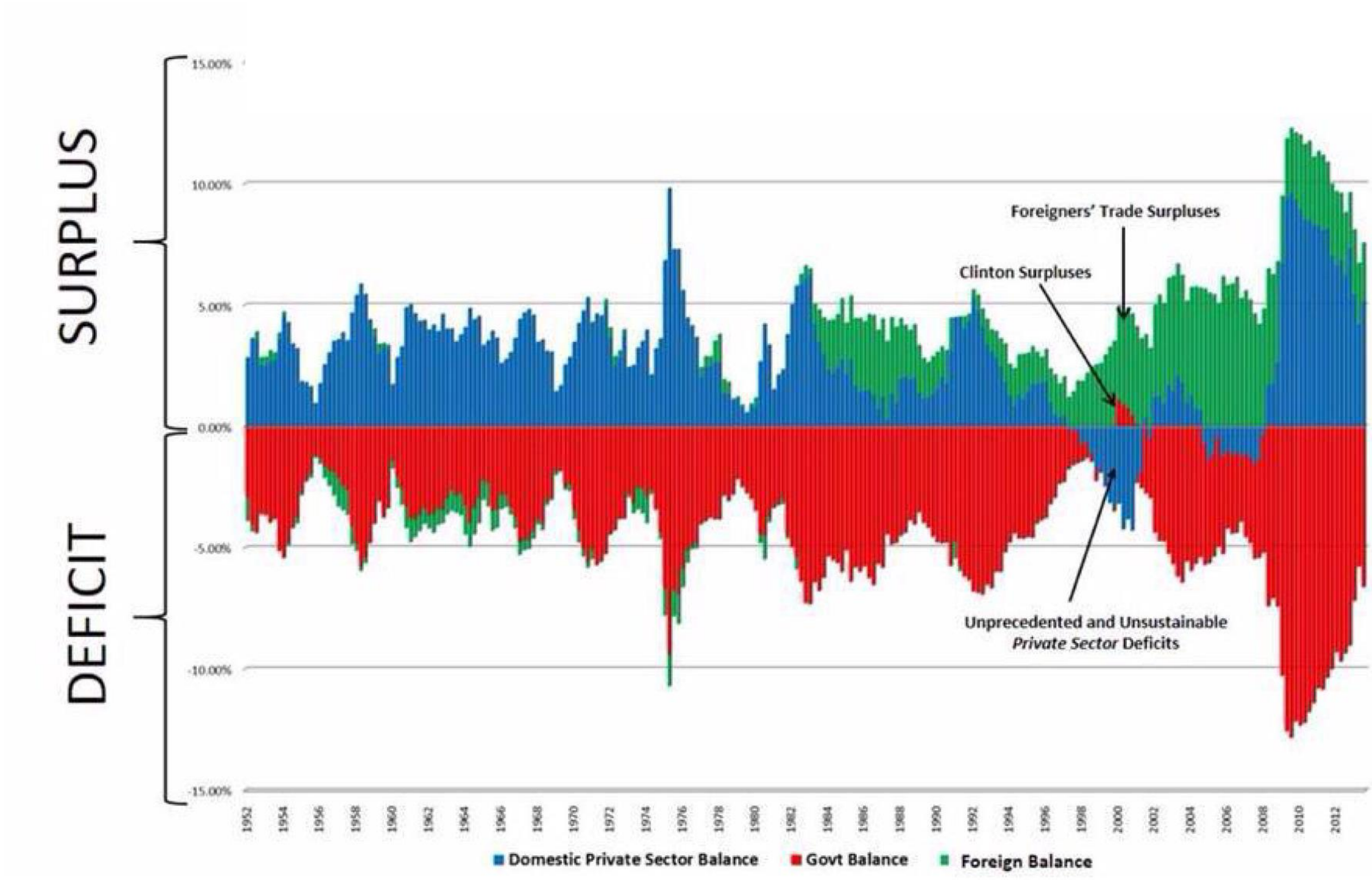
- The **household sector cannot net save** in nominal terms (spend less money than it earns) unless some other part of the economy (or combination of sectors) is willing and able to spend more money than it earns
- It can be government, business, or the foreign sector or some mix of the three
- But keep in mind that the *private* sector is necessarily pro-cyclical; deficit spending cannot be sustained over prolonged periods
- In contrast, a *government* that spends, taxes and borrows in its own non-convertible fiat unit can allow its budget to remain in deficit over prolonged periods of time

The Private Sector Belongs in Surplus

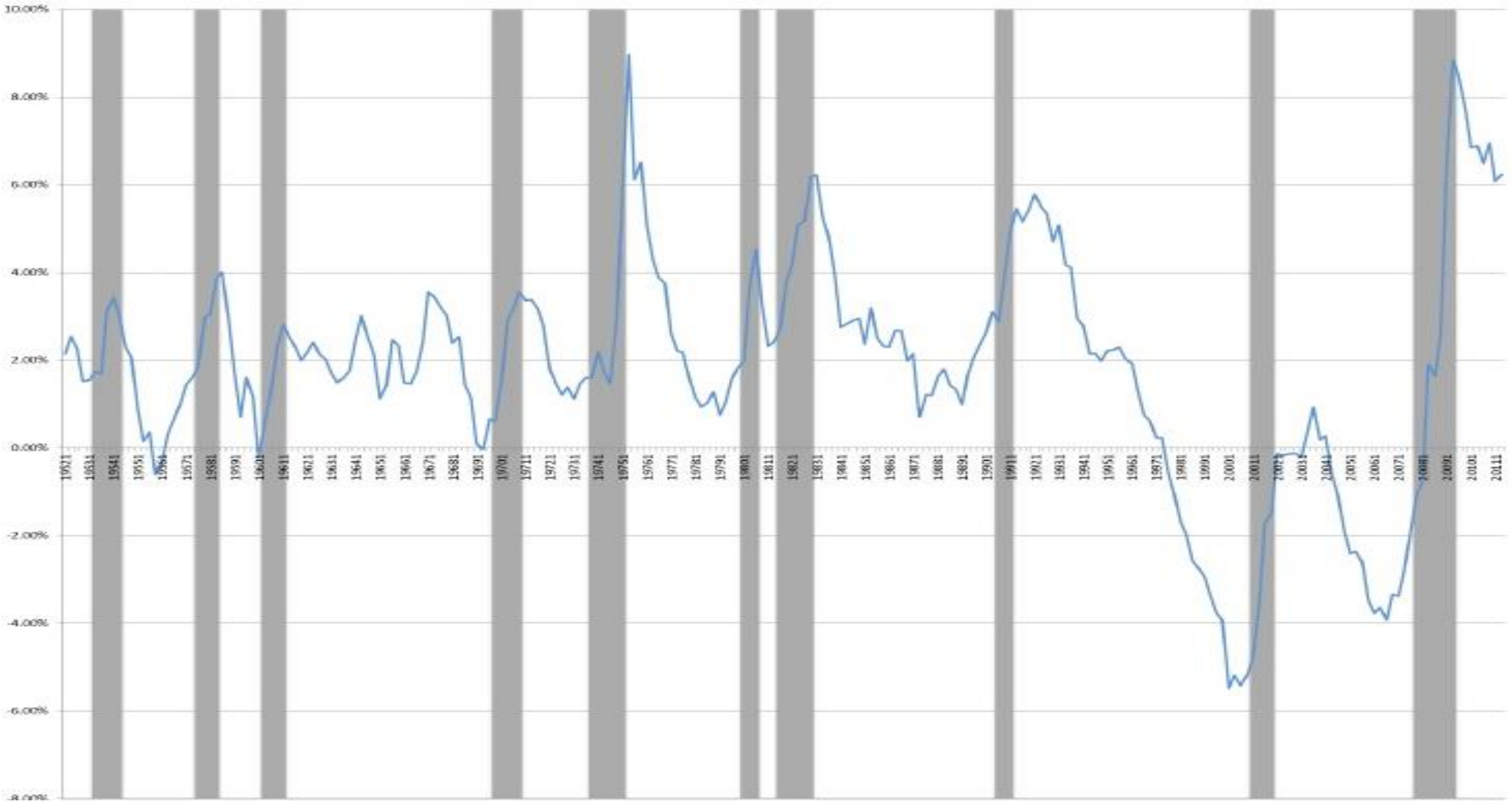
- "An increase in private debt relative to income can go on for a long time, but it cannot go on forever." (Godley, 2000)

- At some point lenders will run out of creditworthy borrowers who are willing to spend

- "When that happens asset prices go sideways, sales soften, jobless claims trend higher, and economic activity falters" (Wray, 2012)


SURPLUS
DEFICIT
15.00%
10.00%
5.00%
0.00%
-5.00%
-10.00%
-15.00%
Foreigners' Trade Surpluses
Clinton Surpluses
Unprecedented and Unsustainable
Private Sector Deficits
1952
1954
1956
1958
1960
1962
1964
1966
1968
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012
Domestic Private Sector Balance
Govt Balance
Foreign Balance

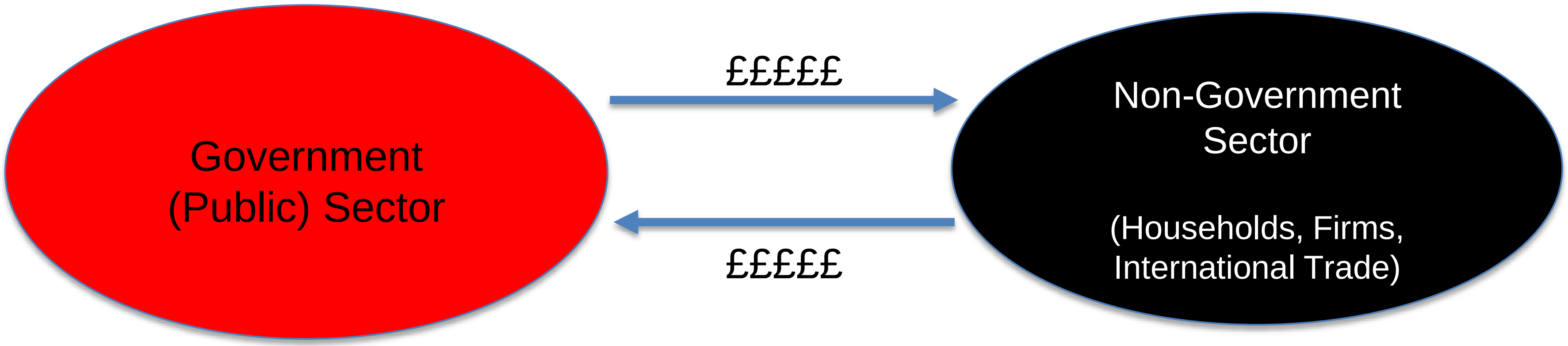
Beware Swings in <u>Private</u> Net Saving



"[I]t would be irresponsible for the government to reduce its outstanding indebtedness when households and firms are attempting to increase their savings."

~Jan Kregel, 2010

By Accounting Identity



Government Surplus = Non-government Deficit

Government Deficit = Non-government Surplus

"Government interventions stabilize the economy by stabilizing profits. with profits sustained, a collapse of income, employment, output prices, investment and asset values does not occur."

~*Hyman P. Minsky*

"In a sense, the budget deficit can be considered an artificial [trade] surplus."

~Michael Kalecki

What Does this Mean for the EZ?

CA Deficit (2012Q1, Millions of €)

Belgium	-1,422
Estonia	-86
Ireland	-1,045
Greece	-4,721
Spain	-14,444
France	-9,626
Italy	-13,067
Cyprus	-718
Malta	-54
Portugal	-1,264
Slovenia	-77
Finland	-1,191
AVERAGE	-3,976

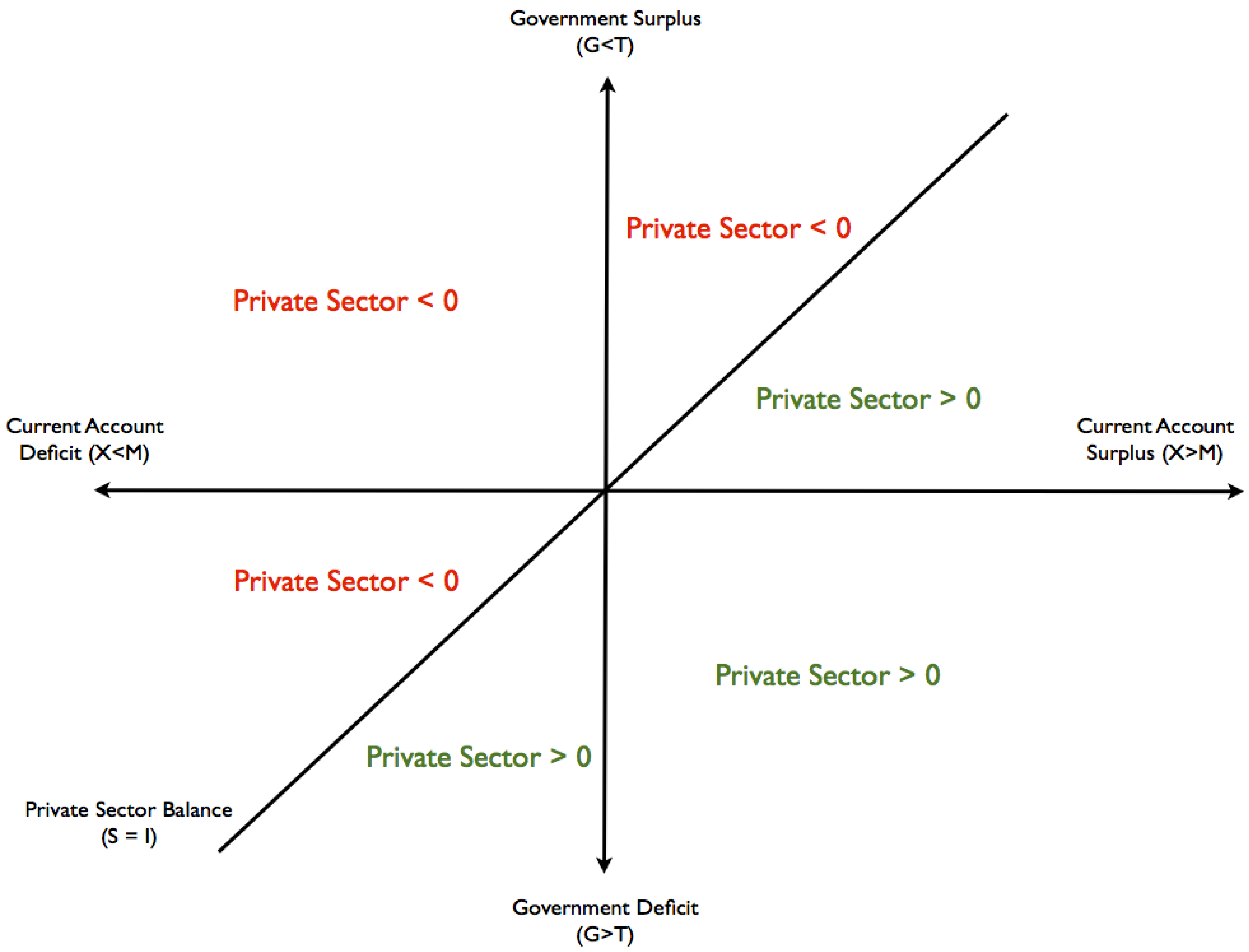
CA Surplus (2012Q1, Millions of €)

Germany	+41,068
Netherlands	+17,454
Austria	+3,210
Slovakia	+648
AVERAGE	+12,659

Fiscal Space with EMU

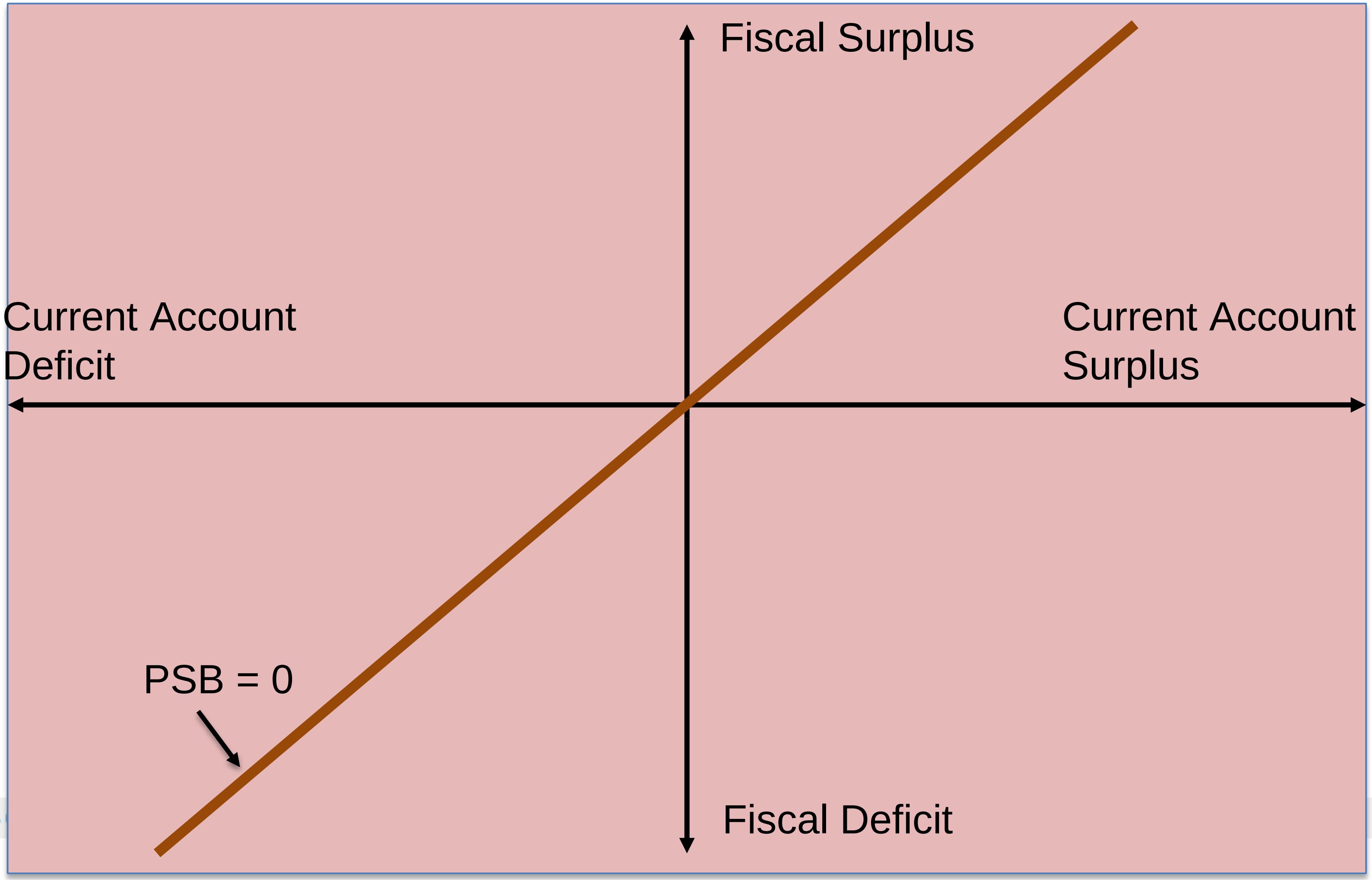
"[T]he power to issue its own money, to make drafts on its own central bank, is the main thing which defines national independence. If a country gives up or loses this power, it acquires the status of a local authority or colony."

~Wynne Godley, 1992



Government Surplus
(G<T)
Private Sector < 0
Private Sector < 0
Private Sector > 0
Current Account
Deficit (X<M)
Current Account
Surplus (X>M)
Private Sector < 0
Private Sector > 0
Private Sector > 0
Private Sector Balance
(S = I)
Government Deficit
(G>T)

Permissible Space for Sovereign Issuers

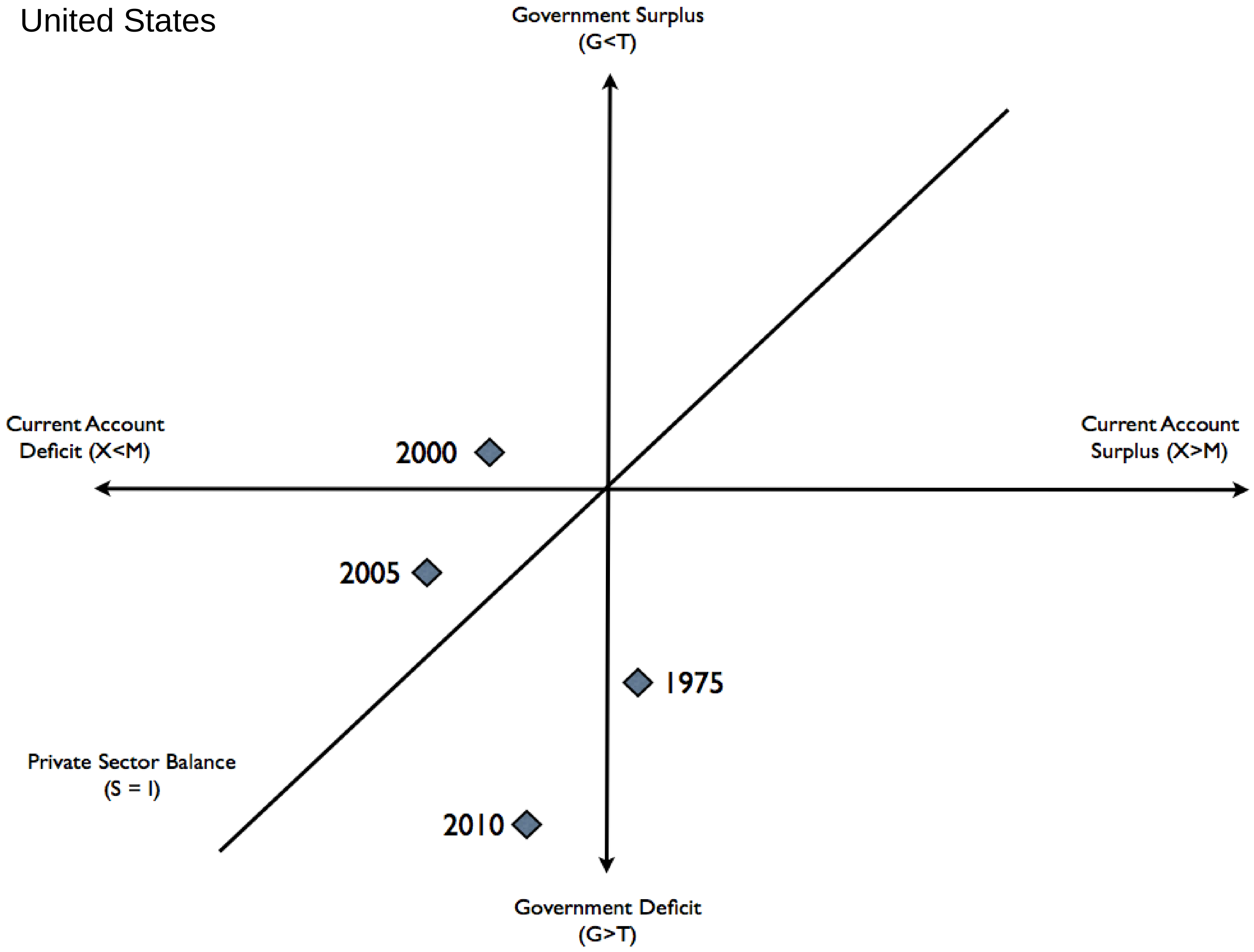


There are No “Market” Constraints

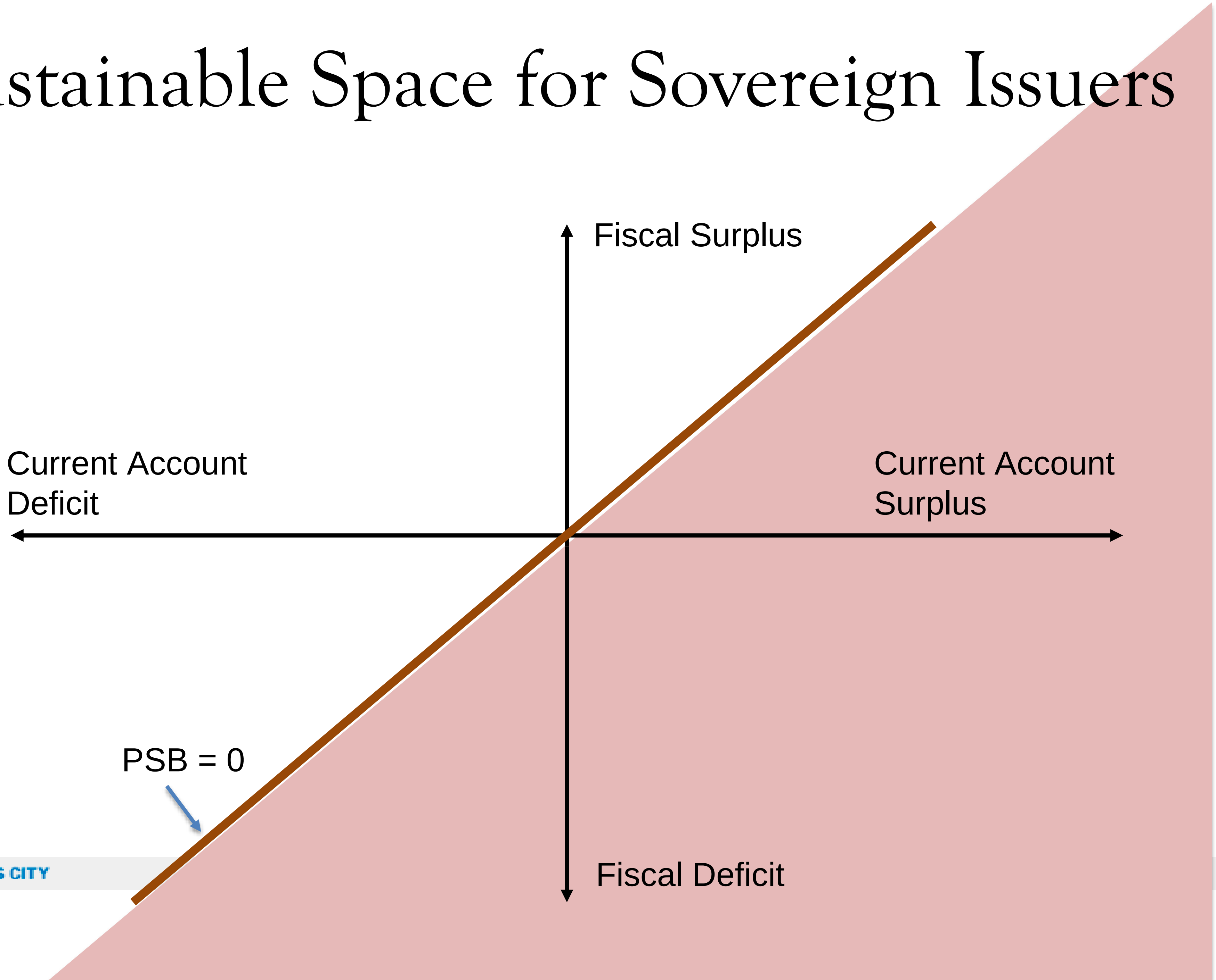
“The treasury can **always** raise money by issuing securities. The bond vigilantes really have it backwards. There is always more demand for treasuries than can be allocated from a limited supply of new issues in each auction; the winners in the auctions get to place their funds in the safest most liquid form of instrument there is for US dollars; the losers are stuck keeping some of their funds in banks, with bank risk.”

~Frank N. Newman, 2013

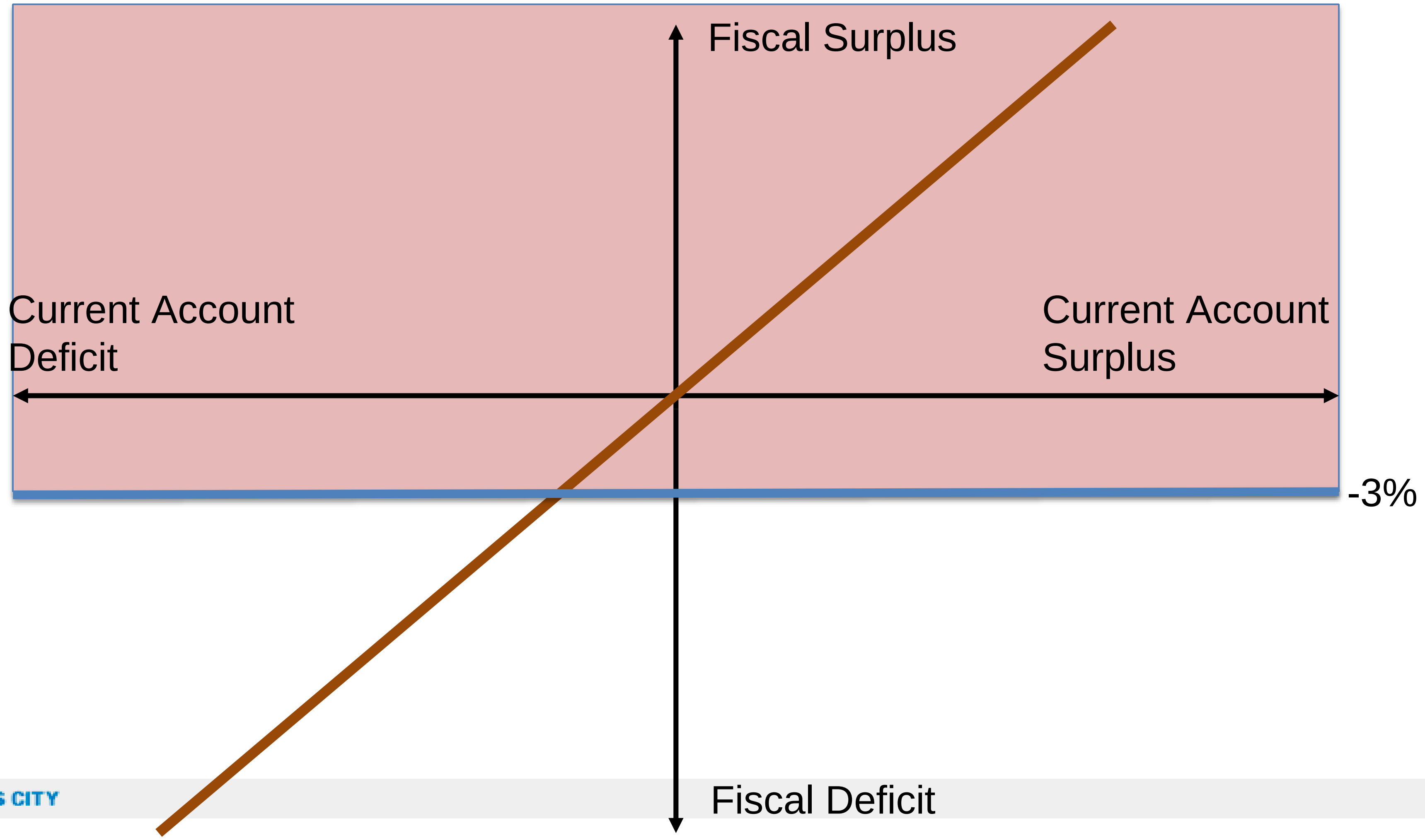
United States



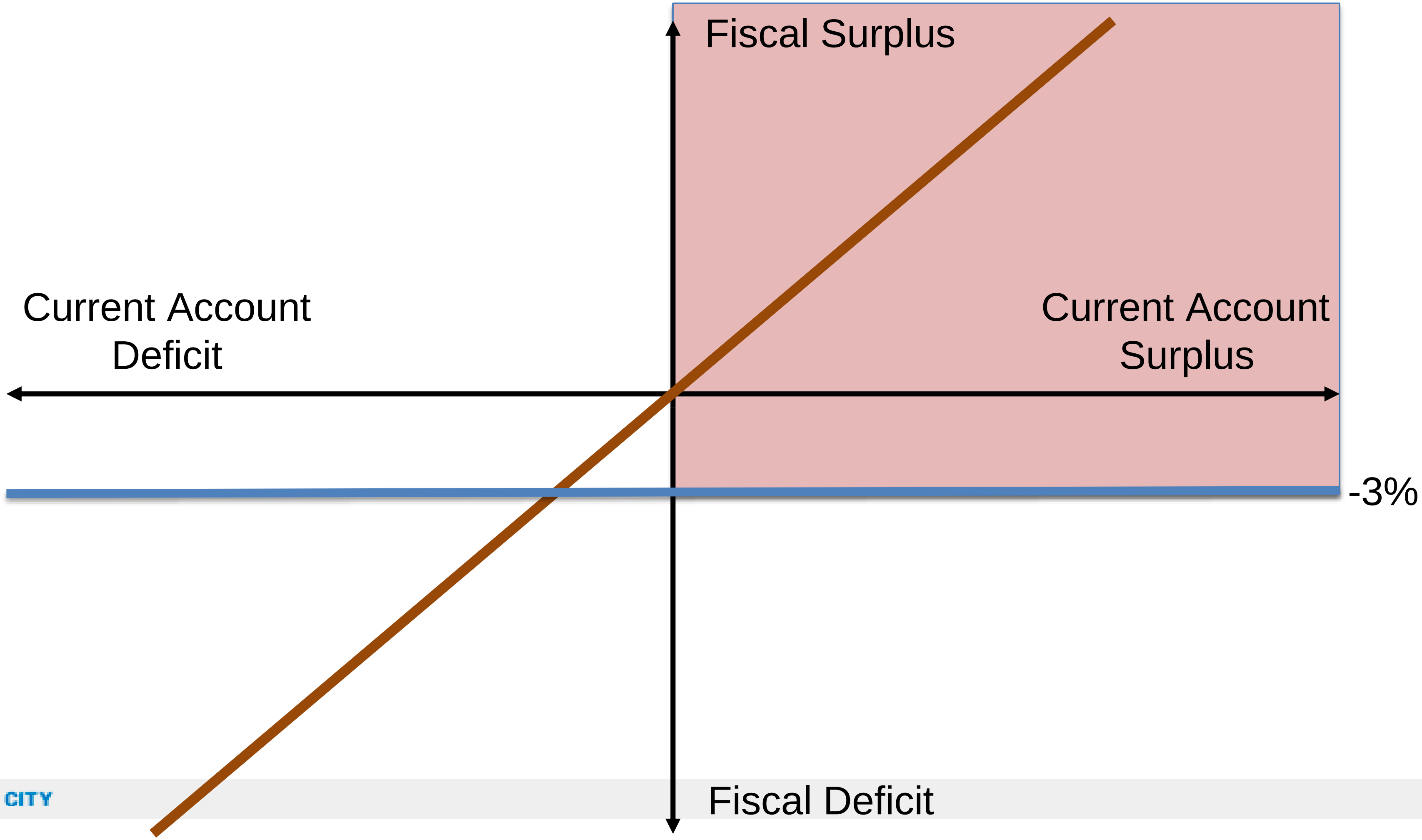
Sustainable Space for Sovereign Issuers



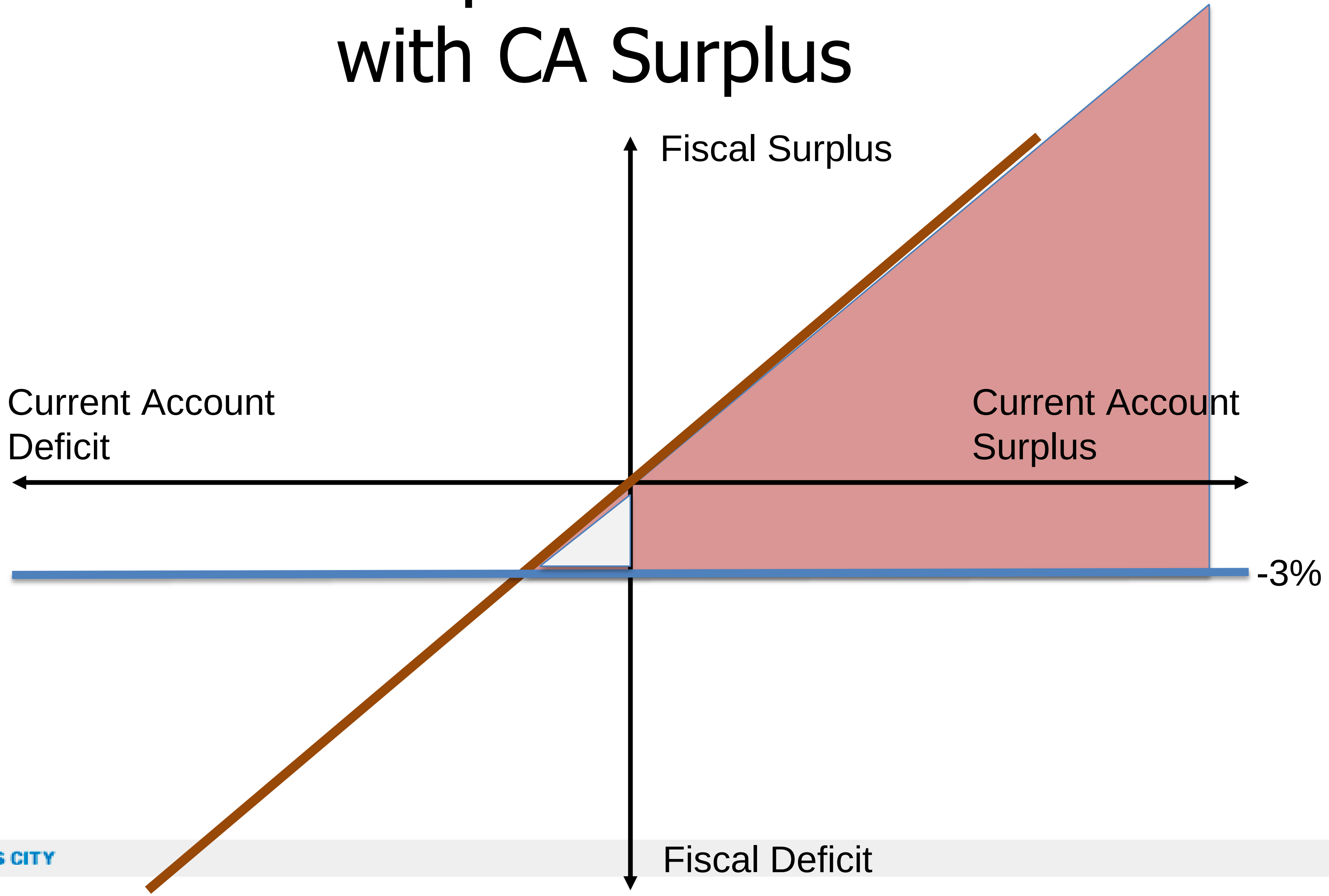
Permissible Space Under Maastricht



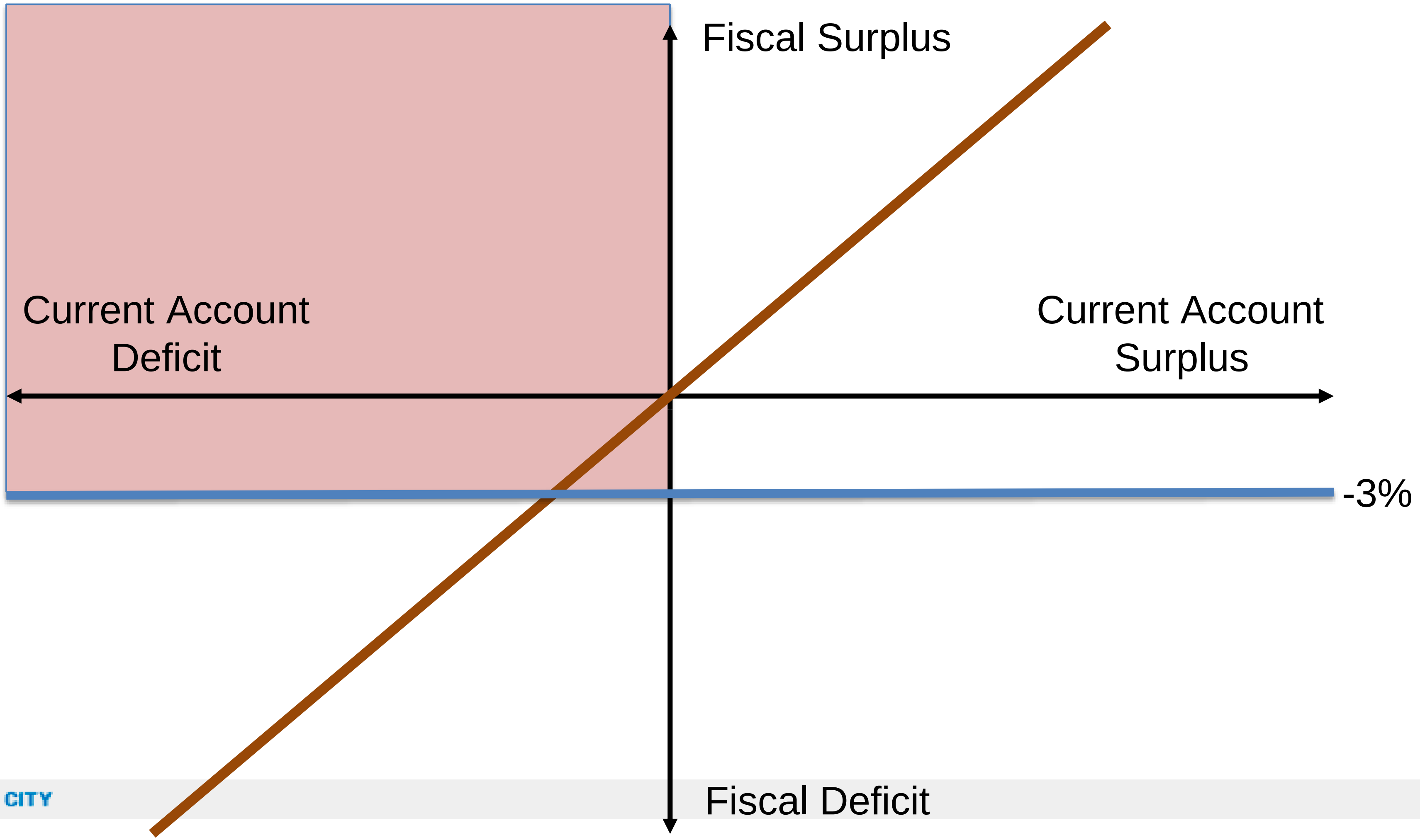
Possible Space for EMU Nations with CA Surpluses



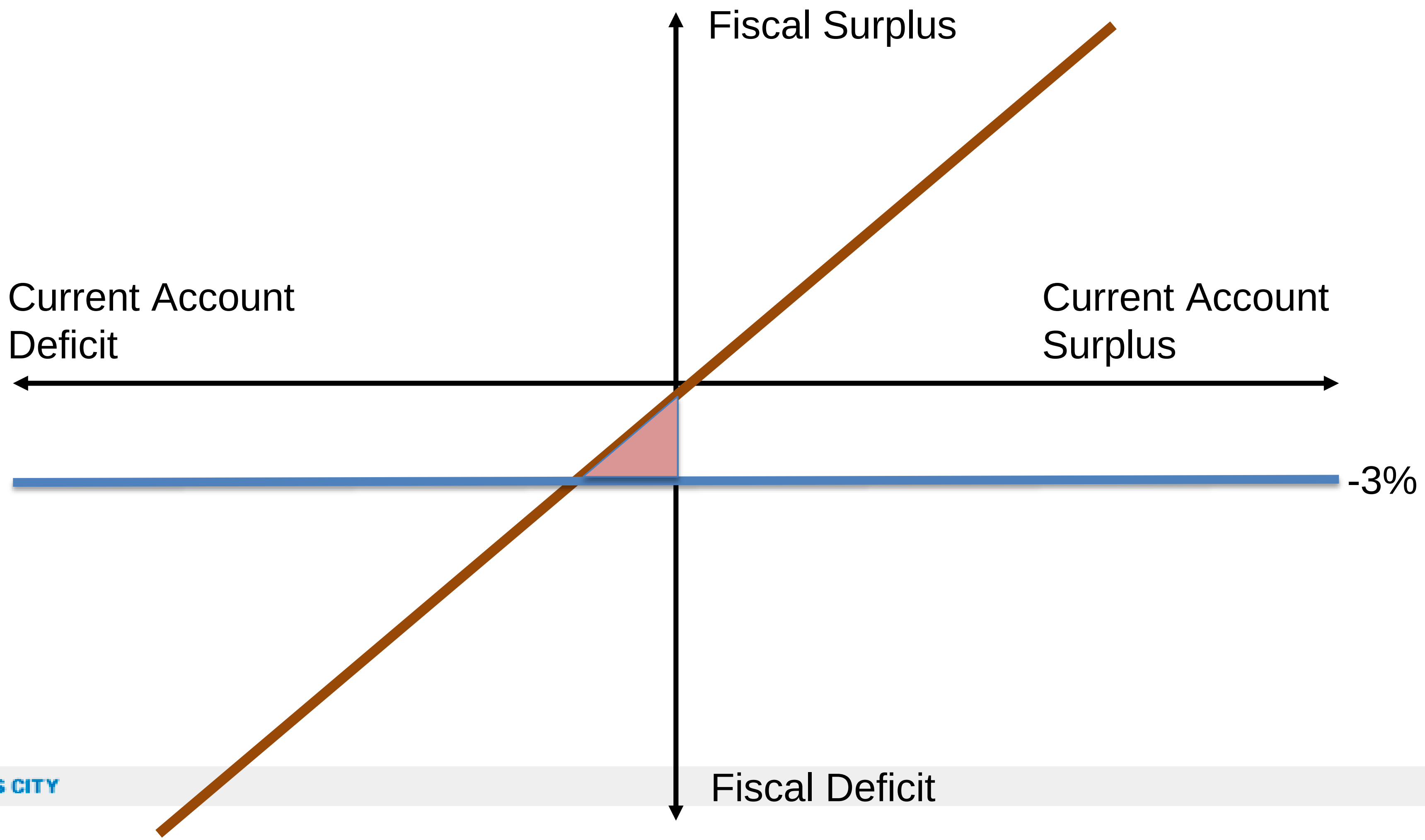
Sustainable Space for EMU Nations with CA Surplus



Possible Space for EMU Nations with CA Deficits



Sustainable Space for EMU Nations with CA Deficits



Bottom Line

- The US, UK, Japan, Canada, etc. enjoy a degree of fiscal space that is not available to most countries in the Eurozone
- For EZ countries, government budget constraints – as usually conceived – are applicable
- Market discipline is a real thing
- One way or another, policy must ensure that private sector balance are almost always (+)

Thank You!