William C Dudley: Remarks at panel discussion on fiscal challenges

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at panel discussion at 2012 US Monetary Policy Forum, sponsored by The Initiative on Global Markets, University of Chicago Booth School of Business, New York City, 24 February 2012.

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It is a pleasure to have the opportunity to speak here today on a panel with Charles Plosser of the Federal Reserve Bank of Philadelphia, and Juergen Stark, formerly of the European Central Bank. Our topic today is fiscal policy–for central bankers always dangerous waters to swim in. I will focus my remarks on the United States as others are better qualified to comment on the situation in Europe and elsewhere.

To start, let me stress that it is essential that the United States put in place a credible program of medium-term fiscal consolidation that addresses our sizeable and growing structural deficits in a manner that is consistent with supporting ongoing economic recovery.

Today I am going to discuss two specific issues relevant to U.S. fiscal policy. First, I am going to highlight the importance of taking the increase in debt service costs into account that will take place when economic conditions permit the normalization of monetary policy. I will argue that we are in an unusual period in which net interest expense is temporarily depressed. This will not last and the fiscal authorities need to factor this in when considering what needs to be done to put the federal budget deficit and the nation's debt burden on a sustainable path.

Second, I will argue that fiscal consolidation should take into consideration the offsetting adjustments needed to keep the economy on an even keel. While fiscal consolidation is a necessary condition for a healthy economy over time, it is not a sufficient condition. Fiscal adjustments require offsetting changes in private-sector spending and saving behavior, and in the trade sector. Prudent economic policies and international coordination can help ensure that such adjustments take place in ways that support economic activity (and, by extension also support government revenue).

As always, what I have to say today reflects my own views and opinions and not necessarily those of the Federal Open Market Committee (FOMC) or the Federal Reserve System.

As we all are aware, the federal budget deficit is very high and the federal debt burden has climbed sharply as a share of gross domestic product (GDP) ***(Figure 1).***

Despite this, the net interest burden on the outstanding debt remains low as a share of GDP ***(Figure 2)***.

This is due, of course, to the unusually low level of short- and long-term interest rates.

These unusually low interest rates are the result of monetary policy actions taken by the FOMC. The sole purpose of these actions has been to promote the dual mandate objectives of maximum employment and price stability in the wake of the financial crisis. The FOMC has stated that it currently anticipates keeping short-term interest rates exceptionally low until late 2014 and this has contributed to the decline in long-term rates. In addition, large-scale asset purchases and the maturity extension program have pushed down longer-term interest rates by removing duration from the private market. As a result, both the U.S. government and private-sector borrowers have benefited from unusually low borrowing costs.

Indeed, the net interest burden data shown in Figure 2 actually overstates the net cost to Treasury. That is because the interest payments from the Treasury to the Federal Reserve are included in the net interest cost shown in Figure 2, but no offsetting adjustment is made for the fact that the Fed remits almost all of the interest it receives from the Treasury and on its other portfolio holdings right back to the Treasury. The Federal Reserve's remittances to the Treasury are included in the budget separately in the miscellaneous receipts category. Thus, one should deduct these receipts from the debt service numbers to properly measure the Treasury's net interest burden.

Normally, this adjustment doesn't change the picture much. However, it is relevant now because Federal Reserve remittances are unusually high. This is because the Fed's balance sheet is unusually large, as a result of asset purchases undertaken to promote the dual mandate, and because the spread between the cost of the Federal Reserve's liabilities (mainly the 0.25 percent rate that the Fed pays on excess reserves) and the return on its assets is unusually high. As shown in ***(Figure 3)***, the Fed's net remittances to the Treasury have climbed sharply in recent years, rising to more than $75 billion per year over the past two years, after averaging about $27 billion over the 2005–07 period.[1]

Subtracting net remittances from the Fed from the Treasury's net interest cost (as a share of GDP), one can see that the increase in our enlarged federal debt has not yet generated a significant rise in the net debt service burden ***(Figure 4)***. However, the low interest rates and enlarged balance sheet, which has generated these reduced borrowing costs, will not be sustained over time. Recall that the Federal Reserve's policy decisions are motivated solely by monetary policy considerations–how best to achieve maximum sustainable employment and price stability.

This means that the ancillary effects on the federal deficit from the Fed's monetary policy actions are incidental and will prove temporary. Eventually, as economic and financial conditions improve, the pursuit of the dual mandate will lead to a different monetary policy stance, one that requires higher short-term interest rates. And, the Federal Reserve will also eventually shrink the size of its balance sheet. These actions will tend to increase the Treasury's net interest costs and pull down the Federal Reserve's remittances to the Treasury. Together, these two effects will sharply push up the Treasury's net interest burden.

To show how this may play out, let's use as an illustration a "current policy" baseline based on information provided by the Congressional Budget Office, including its macroeconomic assumptions. Under these assumptions, the output gap is closed and monetary policy is normalized by 2017. As shown in Figure 5, net debt service is projected to rise to 3.3 percent of GDP by fiscal year 2020 up from 1.0 percent in 2011, based on an assumption that the interest rate for three-month Treasury bills will rise from around 10 basis points today to 3.8 percent by 2020 and the interest rate on benchmark 10-year Treasury securities will increase from around 2 percent today to 5 percent by 2020.

On top of this, Federal Reserve remittances are projected to fall sharply. In its recent current law baseline projection, the CBO calculates that net remittances will decline from a peak of 0.55 percent of GDP in 2011 to a long-run average of around 0.2 percent by 2017 and beyond. Thus, on the current policy baseline, the combined effect of higher debt service and lower remittances will total 2 ¼ percent of GDP by fiscal 2020 relative to the current fiscal year ***(Figure 5)***.

Of course, this assumes that interest rates follow the trajectory used in the CBO baseline. If interest rates rose faster and reached a level 100 basis points higher in 2020 than what the CBO has assumed, the net debt service burden would be about 3 ¼ percentage points higher by 2020, all else equal. Given the uncertainties around economic forecasts that far into the future, it would be highly desirable for the fiscal authorities to put in place a medium-term program of fiscal consolidation now, while market conditions are benign.

At the same time, I think we must be careful and not focus exclusively on the imperative of fiscal consolidation. That is because fiscal policy adjustments have important implications for

[1] The 2011 remittance figure is a preliminary unaudited estimate.

the level and composition of economic activity more broadly–both here and abroad. If we must undertake fiscal consolidation– and over time we must–then we need to be cognizant that this adjustment will need to be accompanied by other offsetting changes in the composition of economic activity in our and the global economy.[2]

One way of illustrating these interrelationships is to use the following accounting identity, which imposes an adding up constraint on the overall economy:

If you define private-sector net saving as the private balance and public sector net saving as the public balance, then:

> Private balance + public balance = current account balance.

At the outset of the financial crisis, the private balance, which was negative, swung sharply into surplus, and this was largely accommodated by a decrease in the public balance–in other words, an increase in the government deficit.

Recently,[3] this accounting identity looked roughly like this:

> 6.5% of GDP private balance + (–9.5% of GDP) public balance = –3% of GDP current account balance

Realistically, the public balance[4] needs to be reduced to about –3 percent of GDP over the next five years or so for the ratio of federal debt held by the public-to-GDP to stabilize around 75 percent to 80 percent of GDP. One might reasonably do more, but this just strikes me as the minimum adjustment that would be prudent and sustainable. This requires a large change from where we are today. For the accounting identity to continue to hold, which it must, there needs to be sizable shifts in the private balance and/or the current account balance. This is not a policy choice – it is basic math – but policy choices can help ensure that the adjustments take place in a way that is supportive of economic activity.

The private balance can be further divided into two pieces–the household balance and the business balance. Currently, for the United States, the household balance is about 2.5 percent of GDP and the business balance is about 4 percent of GDP. As shown in ***(Figure 6)***, which shows these two components over time, the business balance is currently unusually high; that is, businesses have very high cash flows relative to their investment outlays. This suggests that some of the required adjustment could occur by fostering greater investment spending as a share of GDP.

For this to occur, it will be important that economic policies promote long-term growth and financial stability, and ensure that the United States is a competitive place to base production, with a well-functioning infrastructure, a skilled workforce and a reasonable tax and regulatory system.

In addition, it seems desireable that some of the adjustment should take place in the trade sector. Although a current account deficit of 3 percent of GDP by itself would be sustainable over time, for the household balance to remain close to current levels and the public balance to sharply narrow, then the current account may need to move further toward balance.

For this to occur, there needs to be two offsetting adjustments. On one hand, the U.S. economy must be reoriented toward global demand and stronger net exports. On the other hand, there will have to be offsetting adjustments elsewhere in the world. After all, on a global basis, the current account balance–properly measured–must sum to zero. This means

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[2] See "Securing the Recovery and Building for the Future." Remarks by William Dudley at United States Military Academy at West Point, New York, November 17, 2011, for a more detailed discussion of this issue.

[3] Third quarter 2011, the latest period for which data are available.

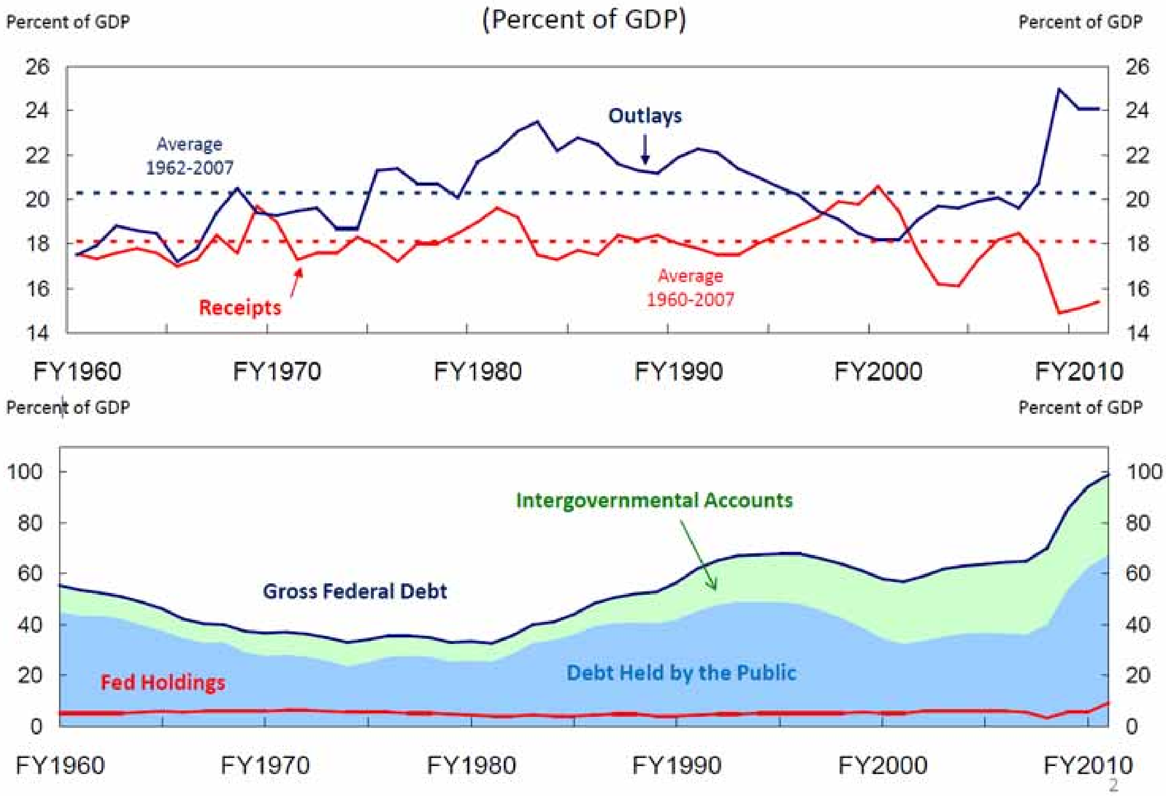
[4] The federal public balance is roughly equivalent, though not identical, to the federal budget deficit; the overall public balance numbers provided here include state and local government.

that countries with significant trade surpluses will need to reorient their economies over time toward increasing domestic demand and running smaller trade surpluses.

To sum up, the United States faces substantial fiscal challenges in the years ahead. And, in one important respect–net interest expense–these challenges may be more daunting than fully appreciated currently. In particular, the interest bill on the growing federal debt burden has been temporarily restrained by the low level of interest rates and high level of remittances from the Federal Reserve to the Treasury. In addition, while significant fiscal adjustments must take place, it is important to recognize that such efforts will necessitate offsetting shifts in private domestic spending and production both here and abroad. Finding ways for these adjustments to occur smoothly is an important challenge for economic policy.

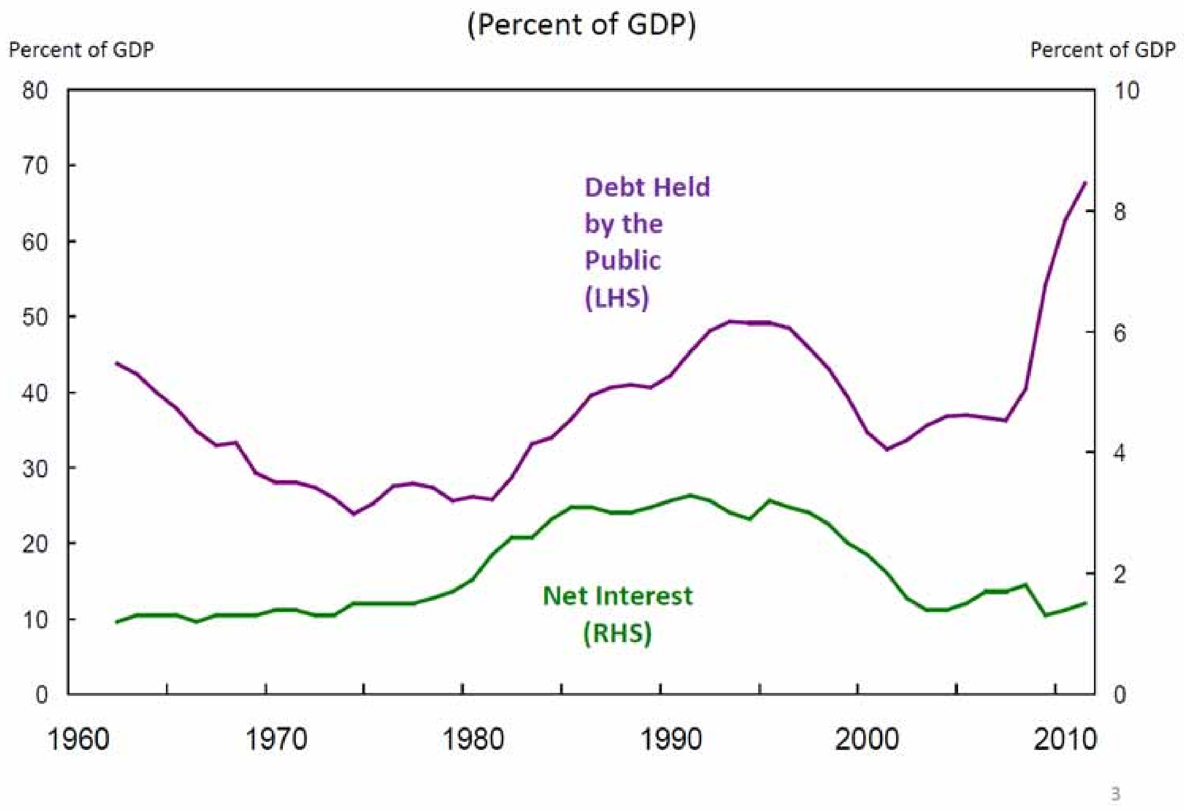
Thank you for your kind attention.

Figure 1: Federal Receipts, Outlays, and Debt



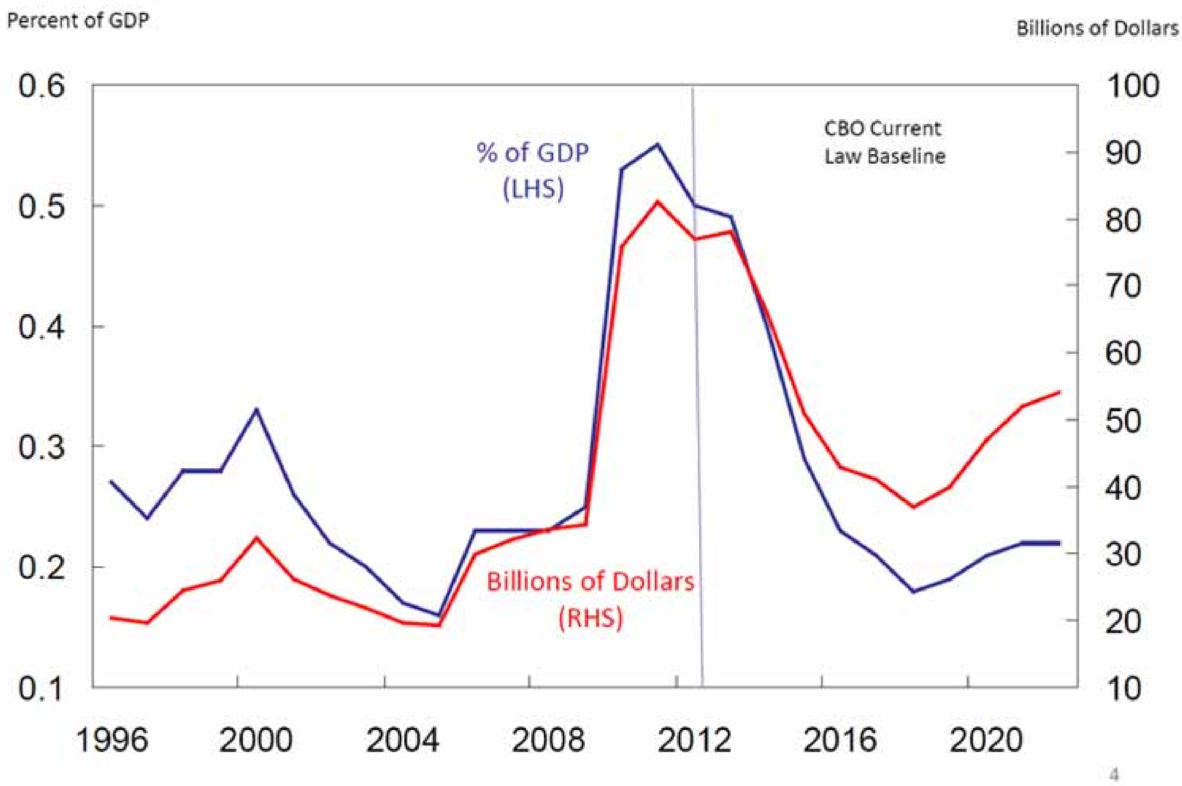
Sources: Congressional Budget Office and Bureau of Economic Analysis

Figure 2:Debt Held by the Public and Net Interest



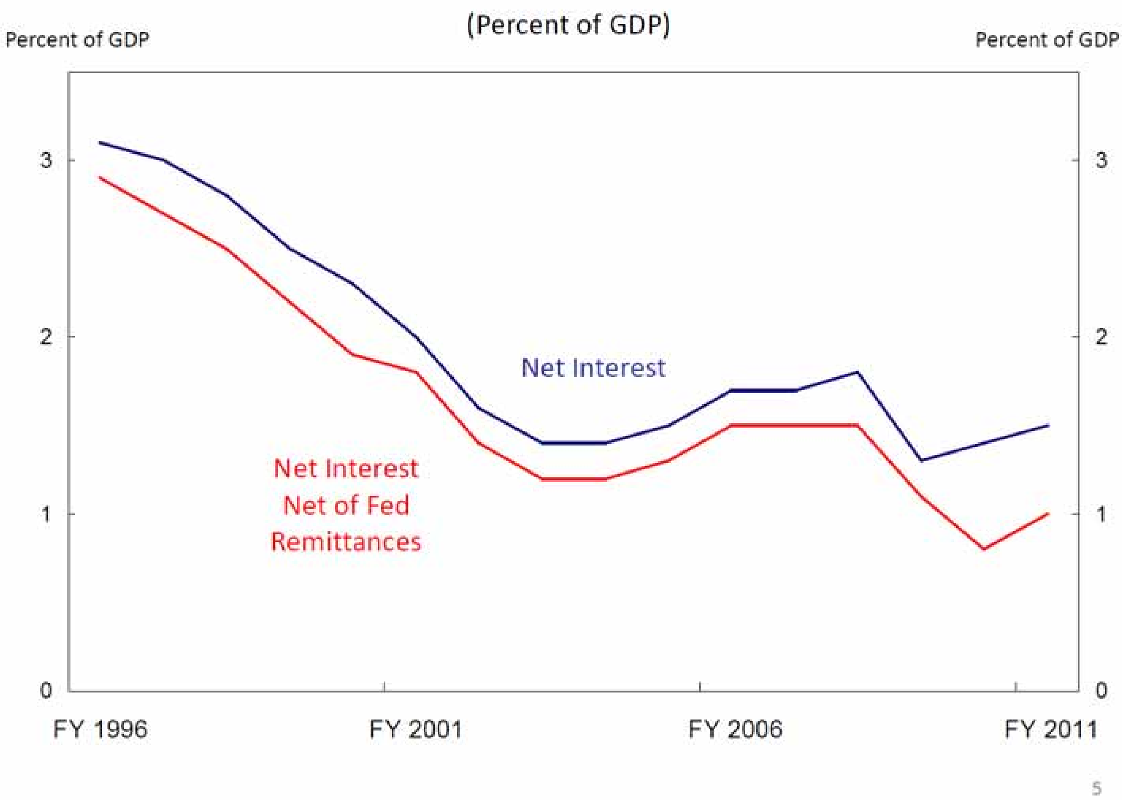
Sources: Congressional Budget Office and the Bureau of Economic Analysis

Figure 3: Fed Remittances to the Treasury



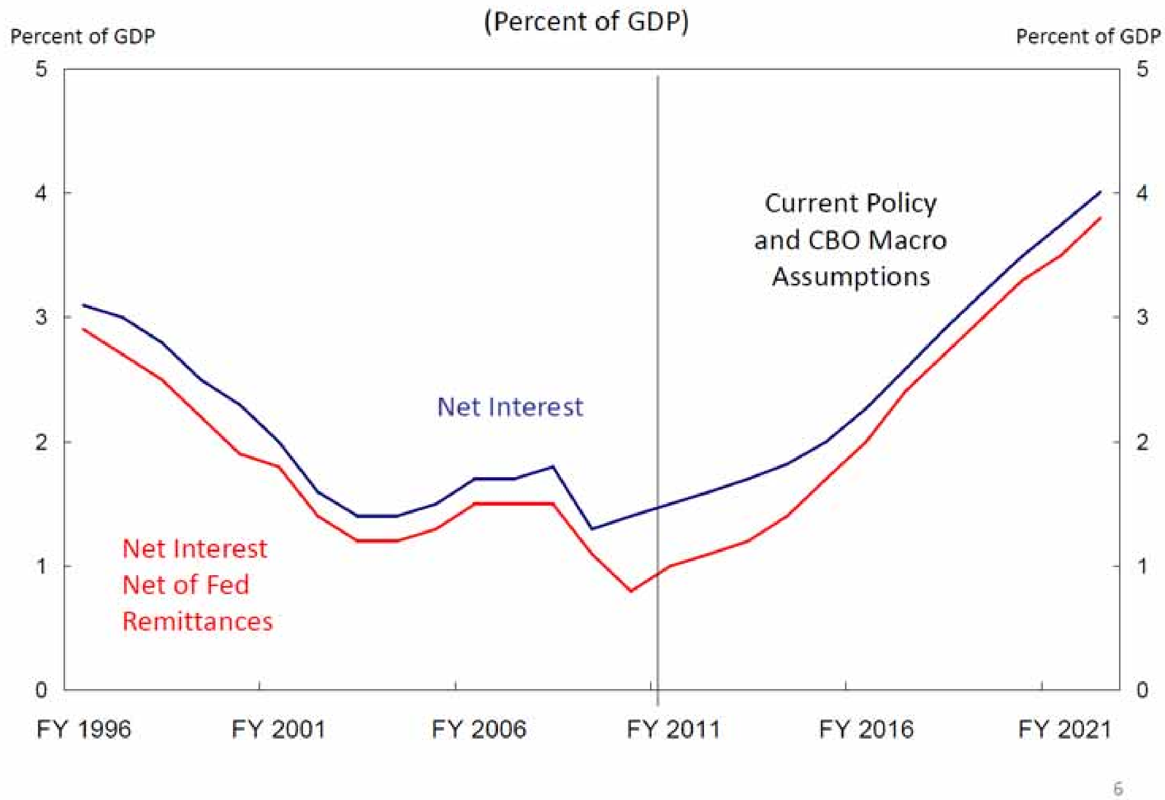
Source: Congressional Budget Office and Bureau of Economic Analysis

Figure 4: Net Interest With and Without Fed Remittances

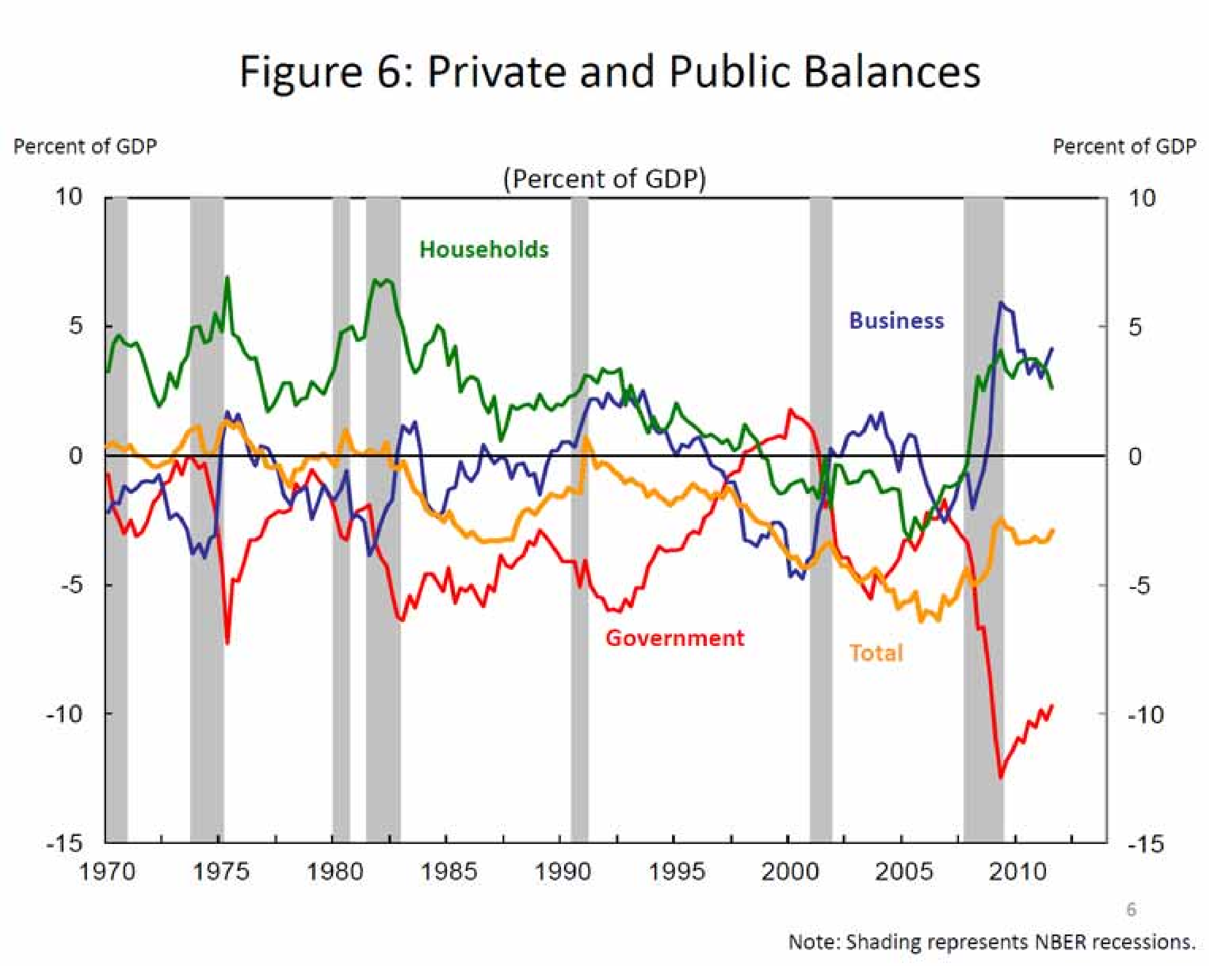


Sources: Congressional Budget Office and Bureau of Economic Analysis

Figure 5: Net Interest With and Without Fed Remittances



Sources: Congressional Budget Office, Bureau of Economic Analysis, and author's calculations



Source: Bureau of Economic Analysis