Panel remarks

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The deterioration in the fiscal position of many developed countries and the questions it raises about fiscal sustainability and sovereign credit risk is a noteworthy development that deserves close scrutiny and attention. However, it has not had significant direct implications for U.S. monetary policy or the Fed's central bank operations to date.[2] Nor have questions about long-term fiscal sustainability for the U.S. had significant implications for the cost of U.S. borrowing or perceptions of U.S. sovereign creditworthiness. Thus, so far the United States has been relatively insulated from such pressures.

That said, I do recognize that this is a major global issue and one we should not ignore in the United States. This is an issue that is more difficult to solve given the aging of the developed world populations. I would also note that these fiscal problems are particularly problematic and difficult to solve when fiscal solvency concerns become interlinked with worries about banking system soundness.

For the U.S., while we face very real long-term fiscal challenges, these are quite capable of resolution. As we saw in the drama surrounding the fiscal cliff talks in Washington, the challenge lies in reaching bipartisan political agreement on tough tax and spending choices. So far, that is proving very difficult.

From the narrow perspective of the Federal Reserve's balance sheet, the issue of sovereign creditworthiness of foreign debt obligations falls mainly into two major buckets – the risks associated with investments of the Fed's foreign exchange reserve portfolio on its own behalf and on behalf of the U.S. Treasury and the risks associated with the Fed's foreign exchange swap facilities with other central banks. On both scores, I would judge the risks to be extremely low.

Starting first with the Fed's foreign currency portfolio investments, the Fed's holdings represent a very small share of its balance sheet. For example, at the end of September 2012, such holdings totaled $25.8 billion, less than 1% of the Fed's total balance sheet, and consisted exclusively of euro- and yen-denominated holdings. Also, the credit quality of such holdings is very high. A significant portion is invested on an outright basis in German, French, and Japanese securities, with much of the remainder invested in euro-denominated repurchase agreements backed by the sovereign debt of Belgium, France, Germany, Italy, the Netherlands and Spain. Also, some funds are invested at the BIS and at other official institutions or held as cash (given the extraordinarily low level of short-term rates).

The Federal Reserve also has exposures via the foreign exchange swap agreements executed with the Bank of Canada, the Bank of England, the ECB, and the Swiss National Bank. As of early December, total outstandings were $12.4 billion, almost exclusively with the ECB. The Federal Reserve judges the risk on these swaps to be extraordinarily low as the dollars swapped are not only secured

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[2] As always, my comments reflect my own views and not necessarily those of the FOMC or the Federal Reserve System.

by the foreign exchange that has been exchanged against the dollars, but also backed by the foreign central banks as counterparties.

With respect to the United States, sovereign risk is an issue that has been very much in the news amid fiscal negotiations in Washington. But there are few signs in market prices that the turbulence surrounding the fiscal cliff has undermined investor perceptions of the creditworthiness of the U.S. in a significant way. Long-term U.S. Treasury yields are extraordinarily low. Moreover, this judgment is reinforced by comparing sovereign debt spreads between the U.S. and other countries such as Canada where the fiscal position looks better and the politics are less difficult. Despite a fiscal agreement that does little to put the U.S. on a long-term sustainable fiscal path, sovereign debt spreads are little changed.

Long experience tells us not to rely on bond markets to give advance warning of sovereign stress, so I don't think we should wait for market pressure to put our fiscal house in order. Waiting will just make the necessary adjustments larger and more difficult. Nonetheless, I think there are several reasons why market concern about U.S. sovereign creditworthiness remains relatively low, despite a rising U.S. federal debt-to-GDP ratio and the very modest progress that has been made in putting the U.S. on a sustainable fiscal path.

First, the U.S. economic outlook – ex the noise surrounding the fiscal cliff – is improving. Thus, the growth prospects for the U.S. look relatively good compared to Europe and Japan over the next couple of years. Positives worth mentioning include:

1. The deleveraging of the household sector is well-advanced. For example, debt service as a share of income has declined back to levels last seen in the early 1990s.

2. The housing sector is recovering. Both measures of activity and prices are improving. This is important not only because the housing sector has been a drag on economic activity in recent years, but also because the decline in housing prices has cut household wealth and impaired households' access to credit. The rise in home prices suggests that these negative impulses are now moving in the opposite direction.

3. The banking system has increased the quantity and quality of its capital and has bolstered its liquidity buffers. Thus, banks are in a position to increase their lending. As a result, credit availability is slowly improving.

4. U.S. corporate profit margins are unusually high and corporations are awash in cash. This means that U.S. corporations have the capacity to increase investment spending significantly.

5. Innovations in oil and natural gas extraction technology have created a significant competitive edge for the U.S. internationally in terms of energy prices. The U.S. dependence on foreign energy sources has fallen significantly and low natural gas prices will undoubtedly spur significant expansion of activities such as petrochemical production in the U.S. where the U.S. now will be the low cost producer.

Also, longer term, the challenge of the U.S. fiscal outlook seems more manageable – putting politics aside – compared to most other industrialized countries. In particular, I would note that the demographic trends in the U.S. are considerably more favorable compared to Europe and Japan. Also, the U.S. has considerable scope for modifying its immigration policies in a way that improves its growth potential and its demographic trajectory and eases the fiscal burden. I would also point out that the U.S. has significant fiscal capacity. In aggregate, U.S. government spending in 2011 was 38.9% of GDP. This compares to 52.8% of GDP for France, 43.7% of GDP for Germany, and 47.3% for the U.K.

Even the trajectory of healthcare spending that is the greatest source of long-term budget pressure in the U.S. seems manageable. While it is true that on current trends, the Congressional Budget Office projects that federal Medicare and Medicaid spending will climb to 9.6% of GDP in 2037 from 5.4% in 2012, there is plenty of scope for the U.S. to better control aggregate healthcare spending. Currently, the United States spends about 18% of GDP on healthcare, compared to a range of 10–12% for most other developed countries. This suggests that the problem is not a paucity of resources, but instead lack of discipline on how those resources are spent.

There is a significant literature in the U.S. that shows that the healthcare dollars could be better spent. For example, big differences in spending regionally across the country on certain types of healthcare services do not result in meaningfully different healthcare outcomes. At the same time, there is no agreement on what type of reforms should be enacted to "bend the cost curve" in healthcare. Thus, this is an issue that is likely to be resolved very slowly over many years.

To sum up, the U.S. fiscal problems are actually quite manageable from an economic perspective. The problem is whether the politics will allow them to be managed in a timely way. Longer term, I believe that the political obstacles will be surmounted.

Finally, some brief comments on sovereign risk. Sovereign risk comes in many shapes and sizes – there is the risk of loss of principal from outright default and from debt restructuring. There is a risk of the breakup of currency union and redenomination risk. There is the risk that currency devaluation could make it difficult for a country to service its foreign denominated debt. Finally, there is the risk of loss from unanticipated, higher inflation. For the U.S., which supplies the world's reserve currency, the only one of these risks that seems particularly relevant is the risk of higher unanticipated inflation.

Let me focus on this risk. First, the Federal Reserve is committed to a 2% inflation objective, which we judge as consistent with our price stability mandate. In other words, we have the will to keep inflation in check. Also, we have the means. The FOMC has the tools to keep inflation in check despite an enlarged balance sheet. The ability to pay interest on excess reserves means that the FOMC can manage the credit creation process so as to be consistent with its goal of price stability. I believe that inflation will run close to our long-term objective over the coming years.

Second, I and other Federal Reserve officials have been very clear that the Fed is not purchasing Treasury securities in order to reduce the Federal government's net interest expense and to hold down the budget deficit. Our policy actions are designed to make financial conditions more accommodative, thereby stimulating a stronger economic recovery. Now it is true that our actions have temporarily held down the Treasury's net debt service costs. But this is a side effect of our policies, not the goal of the policies. And, when the current set of policies is no longer appropriate in order to achieve our dual mandate objectives, these policies will end. When this occurs, the Treasury's debt service costs are likely to increase significantly through two channels:

1. The amount of funds that the Federal Reserve remits to the U.S. Treasury each year is likely to fall back to more normal levels.
2. As interest rates normalize, the costs of servicing the U.S. government debt will increase over time.[3]

The Fed's actions are providing a short-term fiscal benefit, but this is not a benefit that will be sustained over time. The Fed's actions will be driven by our dual mandate objectives, not the fiscal situation of the United States government. I believe it is important that this point be underscored in our discussions with Congress and the Administration, so there is no expectation that central bank balance sheet policy will provide any long-term relief from the tough choices needed to put our nation's finances on a stable footing.

Thank you for your kind attention.

[3] I discussed this issue in more detail last year. See "Remarks at Panel Discussion at 2012 U.S. Monetary Policy Forum", New York City, http://www.newyorkfed.org/newsevents/speeches/2012/dud120224.html.