General Discussion: Achieving Growth Amid Fiscal Imbalances

Chair: Marek Belka

Mr. Carstens: I very much enjoyed both papers. My question is for Steve. His paper was very good, as always. It focuses on trying to estimate the tipping point on the rate of growth versus debt. Of course, this type of exercise always has the limitation that it depends a lot on each country's case. The most relevant question for me is not at what level of debt will I start having trouble in terms of growth, but What is the optimal level of debt to maximize growth? I would ask two questions in that sense. One, How would you go about trying to determine the optimal amount of debt? And, second, Why do countries tend to deviate from that optimal amount of debt?

Mr. Feldstein: I want to comment and ask questions about Steve Cecchetti's paper and particularly about the government debt aspect of it, but not about household or corporate debt. I am as concerned and worried about government debt as anybody in this room, but I have my doubts about the growth regressions. I wonder whether a large and increasing government debt may just be a proxy for other adverse government policies—for spending policies, for regulation policies, for a government that is out of control. There is a big difference between the U.S. debt situation now, where the Congressional Budget Office forecasts we're heading to roughly 100 percent of GDP, and the situation at the end of World War II when we knew why the debt had exploded to 106 percent of GDP, but was about to start coming down through a strategy of balanced nominal budgets over 15 years. So expectations are very important.

But, even if the growth regressions are not persuasive and even if there isn't a link between government debt and growth, there is between government debt and the level of real income. Steve said in a closed economy, "Well, we just owe it to ourselves."

But that is not true, because there are taxes that have to be collected for debt service. So when you have a debt that is almost 100 percent of GDP, you are collecting a lot of taxes, pushing up marginal tax rates, and reducing real incomes. Of course, there is also the crowding out that goes with issuing of government debt, reducing the capital stock, and reducing, therefore, GDP.

Steve talked about the positive effect of government debt for macromanagement. But, of course, you don't have to have a growing government debt to do that. The cyclically balanced budget would avoid increasing debt, while still allowing a government to have deficits and surpluses.

Mr. Kandel: My question is more technical for Steve's paper. You seem to treat the three types of debt independently. There should be some substitution between them and maybe some reinforcement of one versus the others. Do you have any idea how to treat that?

Mr. Silvia: Steve, your paper starts out feeding right into the sovereign debt work a lot of people do, including us. First of all, I obviously look at this as a stock-flow problem. You are looking at the stock of debt, compared with the flow of income. On page 1, you are talking about the level of growth rates and that may impact the estimates that are done. For example, on page 5, "if debt follows a trend, then the rate of growth of GDP is critical to know."

That helps explain your comment about why the long expansion of the 1990s was characterized by stability in the public debt-to-GDP ratio. Knowing the rate of growth is absolutely key.

On page 9, should you run a causality test between debt and GDP before doing the calculations in Table 2? My question is because the model you test only runs one way and it may be there is some causality running the other way.

In Table 5, which you reviewed in your presentation, the corporate and household debt variables are not statistically significant in the baseline model. When you include the financial flow variables, the corporate is statistically significant only in the second case, where you do not control for the banking crisis. If not statistically significant, then can you really claim that certain debt levels are significant as policy benchmarks? I noticed in your presentation, Steve, that you did mention that households were not relevant or of considerable value.

Then, in Table 6 on page 18, under these three threshold effects, would they be impacted by the rate of growth? You have to know the rate of growth in the economy and you have to look at the stock-flow problem to be able to identify these debt equations. And it feeds into Martin's comment about trying to understand the growth equations overall.

Mr. Meltzer: Steve, I am glad to see people are paying attention to debt and the Bank for International Settlements (BIS) continues to beat that animal, which needs to be beaten. I worry about a study of debt, which looks at the debt and its effect on GDP without talking about what the money is borrowed and used for. If the debt is 100 percent and it is financing productivity growth of 10 percent a year, what's the problem?

The problem for the United States and many other countries is the public debt is being used to support redistribution. This maybe has many social benefits and may be politically desirable but it has lower productivity growth because it drains resources away from productive investment and into consumption or transfers. That seems to me to be a missing element in the whole paper. It borders on what Katherine is talking about. If Katherine got her way and her policies were adopted and the productivity of health care shot up, wouldn't the debt position in the United States look very different?

Mr. Cecchetti: First, thanks for all of your comments. A number of them suggest what the next paper should be, so I am glad we are off to such a positive start.

Maya, you asked a really great question about spillovers: What happens if everybody is consolidating their fiscal policy at the same time? The technical answer for that question is that it is not in the data so I have no idea. But this is a copout. The real answer is, if we were to try to build a more comprehensive model, which the International Monetary Fund (IMF) has done in some circumstances and other institutions have done as well, you can look at the spillovers. The answer is that they matter, but it is hard to say how much.

But there are two mitigating factors you run into here. The first concerns the demographics. Not every country is getting old at the same rate at the same time. And the other is that not everyone has fiscal problems of the same magnitude, if at all. So it is not literally everybody that needs fiscal consolidation at the same time; it is everybody in the advanced world. That is pretty bad, but it is not everybody.

You also asked how expectations about future fiscal trajectories might have an implication for what is happening now. That is a good question. I don't have an answer, so we have to think about it.

Marty, you and Allan make similar points. When shown that additional fiscal debt is bad for growth, might we just measure the impact of bad versus good government? We thought about this, and looked for independent measures of the quality of government. Unfortunately, existing measures do not go back long enough. Remember, however, that we do include country-specific fixed effects in our regressions, so to the extent that a country's government is consistently good, consistently bad or consistently mediocre, we have controlled for it.

On the question of the relative importance of different types of debt, whether they are substitutes or the like, we have only looked at whether they are in some sense perfect substitutes by adding them together. They are not. Beyond that, we leave it to others.

Finally, I come to Agustín Carstens' extremely difficult question. Can we determine the optimal level of debt? Let me say that I would not look at the thresholds as somehow being the peak of some sort of point at which things are becoming optimal. What I will do, and this gets back to Marty's point, is say I want to run an economy at lower levels of debt than those thresholds suggest – substantially lower. Authorities need room to borrow if disaster strikes, either natural or man-made.

Agustín's question gets back to something I've thought about unproductively for the past five years or so. What is the right debt-equity ratio for an economy to have? What is the right level of claims that are bond-level-like claims on the income of the economy versus the residual claims on the income of the economy? And how should I structure that? For that, I don't have a very good answer.

This is a complicated question that requires solid economic models combined with some good empirical work. I hope over the next five or 10 years someone produces those models and that empirical work so that we get the answer.

Mr. Başçi: I would like to ask Stephen about this tax treatment. You just touch upon it on page 3, but go no further than that. The interest expense is deductible from corporate income tax, but dividends are not. This is cited more and more nowadays. So why don't we just reduce this tax deductibility to help both the fiscal deficits and debt and also the corporate debt as part of the solution?

Mr. Alshabibi: My question is also to Stephen, with respect to the fact we have been doing a lot of work on debt sustainability analysis. We service the debt, as long as the debt does not hurt the growth prospects of the country.

Since you have been doing a lot of debt sustainability analyses with a lot of international organizations and also domestically—of course, obviously the methodology is different—but in terms of policy conclusions and policy recommendations, to what extent would your analysis be different from debt sustainability analysis?

Mr. Mohan: First, I'd like to congratulate both of the papers for being very informative and excellent. I have two questions—one for each of the papers.

First, for Stephen, what is striking to me here is the commonality of the debt level and debt growth across all North Atlantic economies plus Japan. It is not an issue that is of particular relevance for the United States. The question raised in my mind is: Why has there been such a commonality in this increase in debt levels for all the OECD economies? The data you have for the period 1980 to 2010 also coincide with the information in Dani Rodrik's paper on growth declining in all the advanced countries during this period.

So the question is somewhat similar to what Allan Meltzer and Martin Feldstein are asking and that may be what you address in your next paper: Are there some threshold levels for government expenditure and tax revenues, as a proportion of GDP, which are bad for growth? What are the tipping points there? Obviously, all of the countries collectively have been spending far more than what they have been collecting as revenues. Either they have been spending excessively badly or their tax revenues are far too low and that is affecting growth.

The question for Katherine and Amitabh: what is most striking to me is the question you don't address in the paper: why is the United States spending on health twice that of the rest of the advanced economies? I would have thought that is the real question. Presumably the health of the Europeans and the Japanese is not much worse than the Americans. Why does the United States have double the expenditures? It seems to me there must be an easy answer for the United States—just do what the others are doing and halve the expenditures. That is a question you don't address at all in the paper and that really surprised me.

Mr. Redrado: Steve, you have made a contribution through the econometric analysis developed in the paper. However, if you want to use your conclusion for public policy analyses and purposes, the threshold of debt/GDP ratio should not be considered in isolation.

From my point of view, consistency of the debt to GDP ratio with the overall macroeconomic framework is very important. It is very likely, that the consistency between fiscal, monetary, and exchange rate policies have a significant effect on the estimated thresholds. An economy would benefit from higher levels of debt in terms of its impact on economic growth if the available economic policy instruments are fully operational for the country. Economic policy instruments also have an effect on the composition of debt (e.g., domestic vs. external, foreign-currency denominated vs. local currency debt, short-term vs. long-term). All of these are relevant for any macroeconomic analysis.

I am also remembering a paper I've read by Alan Auerbach at the last BIS conference, about long-term sustainability for advanced economies. Taking into consideration just the ratio of debt to GDP, without considering the political environment and fiscal institutions is insufficient and could lead to an incorrect conclusion. The case in point was Italy and Japan, that have maintained much higher debt-GDP ratios than other advanced countries for long periods of time.

In the case of Italy, the fact that a significant portion of the debt was in the hands of domestic holders, had significant implications in the liability management. My point is, how would you apply your threshold given the different macroeconomic policy frameworks that each country has? And is your threshold to be taken as a one-size-fits-all for all countries?

Mr. O'Brien: Stephen, I'd like to follow up on these questions of why the debt buildup occurred, because there has to be something endogenous to the political process. I would submit that your paper, and the other research in this area, isn't really going to convince the politicians. My question comes from the standpoint of an investor. Do I expect endogenous change to fiscal policy, endogenous change to debt levels, or are the markets going to have to intervene to force or compel some reduction in public debt levels?

Mr. Cecchetti: Let me start with Erdem Başçi's comment about the tax treatment of debt. This is a big deal. Tax system prefers debt, and as a consequence there is too much debt. But, since tax codes change very infrequently, it is difficult to see taxes as a spur to the explosion in debt during the run-up to the crisis in the first half of the last decade.

On the point about debt sustainability computations and the usefulness of this information: Debt sustainability computations require an assumption about the growth rate for an economy. What our work does is to point out that growth rate is in some sense endogenous. When debt reaches some level—we say around 85 percent—it becomes a drag on growth. This makes sustainability more difficult.

On Rakesh Mohan's comment about the commonality across the OECD, I would point to Raghu Rajan's excellent book in which he suggests that this was both a companion to growing inequality. Inequality has been growing in the entire industrialized world, and Rajan suggests debt has been a way to keep political peace. I do not necessarily subscribe to his conclusions, but the facts are clearly there: more debt has come with more inequality.

In his comment, Martín Redrado points to the complications of applying the lessons of our work in isolation. He is absolutely right. What a policymaker would want to do about ballooning debt levels, how fast, depends on what's happening elsewhere in your economy. I am not sure I would point to Italy and Japan as examples of cases where you can have high growth and high debt at the same time, though. They certainly seem to be examples of where you can have low growth and high debt at the same time. In any case, I think Martín is right; there are interactions.

Do I expect endogenous changes in debt levels? This gets back to a point that Maya made. As she said, we need credible consolidations, and hopefully we can get them without too much market pressure. I couldn't agree more.

Mr. Chandra: Let me see if I can answer your question: Why is it we spend so much more than Europeans? There are three ways to think about this. A small portion of the higher spending in the United States is because we are sicker. So, if you were to measure diabetes levels, obesity levels, hypertension levels, C-reactive protein levels in the United States relative to, say, the United Kingdom, we are sicker. That's a small part of it.

The second part of it is not that we do more hospital admissions or more physician visits. It is what happens inside that hospital admission or what happens when you walk into a doctor's office. So, in the United Kingdom, you might be referred for an X-ray. Here you would probably get a CT scan, which is a much more intensive way of imaging and diagnosing a particular treatment.

The third is, of course, our social insurance programs, Medicare in particular, are prohibited by law from using cost-effectiveness analysis to decide whether something should be covered or not. If some new drug company or some new device manufacturer devises a drug that costs $91,000 and buys you three weeks of survival, that is likely to be covered. The Europeans have figured out a way to have that conversation about what will be covered versus not. Americans are much comfortable saying, "We will give infinite health care to 80 percent of the population and nothing to 20 percent," because we don't have a way of saying, "Gee, if we just didn't cover that fancy, shiny new technology, maybe we could give health insurance to somebody else."

Those are the big three questions. This reimbursement system, in turn, results in a bunch of endogenous R&D. If you have a reimbursement system that rewards without regard to value, device manufacturers and drug companies will occasionally develop wonderful technologies, as they have. But occasionally they will come along and say, "Well, this is not particularly useful, but we have developed it because there is a payer out there."

So we have to give the endogenous R&Ds a big component of why the United States leads in developing a lot of these technologies, as well.

What is it that we can do? It is outside our area of expertise as economists, but at the end of the day—now I am speaking not as an economist—we have to get Congress out of this business of deciding whom to cover versus what to cover. We probably have to create an agency that does this. It might mimic the Federal Reserve Board, or something like that, and it will probably set targets. There will be a person and he'll probably say something like, "Gee, health-care spending in Medicare and Medicaid should grow at GDP or GDP+1 and these are the rules we will use to decide who will be covered versus what will be covered."

That is a conversation I have never seen happen in the United States.

Ms. Malmgren: The thing that concerned me about the work you have done we were discussing here today was this idea it comes down to some rational technical decisions and if only our politicians could make them. My concern is the magnitude of the debt is now so large that any solution tests the limits of human pain tolerance.

Isn't the real issue that what we have to have is a renegotiation of the social contract between citizens and their state about the relative rights and responsibilities of taxpayers versus the state, which is now indicating it can't follow through on the promises that have been made? This is something decided at the ballot box or worse in the streets, not something subject to econometric modeling. My question is, What do you think about this being something more like a renegotiation of the social contract, rather than a series of technical, rational decisions that have to be made?

Mr. Prasad: I have a question for Katherine and Amitabh. This paper was fascinating because until the United States controls its health-care costs, it's going to have significant implications for fiscal policy, which is going to affect the rest of the world. So the fact you didn't have many questions in this audience is not a reflection of the importance of this issue.

Let me ask about how you framed them. In the discussion you talked about a number of these policies that would deliver better health-care efficiency. But, linking it to the broader theme of this conference, what about other aspects related to growth? Which of these policies helps productivity growth? Which of these policies perhaps helps the labor market work a little more efficiently, so it can deliver productivity growth? If you think about which of these policies from a much broader policy setting is going to work better in terms of long-term growth, are the answers as obvious as they are in terms of this much narrower focus you have taken?

The second question is about the issue of health-care spending. We have talked about various levels of health-care spending. Do you have some sense about what is the right level of health-care spending? This is going to change over time as demographics change. But is there anything from these cross-country comparisons we can say about what is an optimum level of spending? And, in particular, what is an optimum level of public spending?

One could think, for instance, about the fact that China provides too little social expenditure on health care, and education as a matter of fact, so people self-insure, which is not very efficient. That brings down the ability of the Chinese economy to transform itself the way they would like. Do you have some sense of how best one should think about the right level of spending and how much of it should be done by the state versus private mechanisms?

Mr. Frenkel: I would like to come back to the issue of the debt. Much of the discussion of the debt was in the context of "things are going OK. Let's look on the long-term implications of this stock of debt on growth."

I would like to go to the scenario in which things are not going okay. The concept of "let's inflate the debt away"—that concept and the dangers would not have a reason, if there were no debt. In other words, the very existence of debt is providing and creating some vulnerability to terrible policies that in the absence of debt would not be there. That is when things do not go so well.

The second issue is related to it—it's the uncertainty. The uncertainty about how this debt will be paid and whether it will be inflated away, whether there will be another future tax liability, and who will pay. That environment is also impacting growth—the origin of the debt.

Allan Meltzer asked, "What is being done with this debt?" I want to bring the question of Where did the debt start from? Let's take the current situation. There was excessive leverage of the corporate, housing, and financial sectors with the crisis and an immediate very large deleverage. In order to offset the macro implications of this deleverage, many governments decided to leverage their own balance sheets. Much of the debt arose by trying to offset a previous deleverage that arose from a previous excess leverage.

How do we think about all of these seesaws in leverage, where it is not only public debt, but public and private debt? Finally, as I am sitting, if the debt of Greece and Portugal was not so much external debt, would they be the Achilles' heel of Europe, as they are now? So that is the notion of the external versus domestic.

Mr. Gurría: Thank you for the paper, Stephen. First, you have to stop the rot here. The problem is that the levels they say are the critical levels have mostly been achieved. This is the first very serious warning signal coming out of here and one that has to be loud and clear. It is beyond that actually in many other cases and we are moving very fast. We have not yet even stopped the rot. By the time we stop the rot, we are going to find ourselves at the top of Mount Everest. You can't breathe there; there isn't much oxygen.

So you have to come down. That is the second, big fiscal consolidation effort to where you can breathe, maybe not to pre-crisis levels but something more manageable that will not consume so many resources.

By that time, you are feeling a little bit better and aging comes in and hits you. That is the third big effort you have to make. This consolidation effort is going to take a generation, if we get it right. It is a very, very serious matter and, of course, it is a big trade-off. How do you continue to nourish the weak recovery and take a very serious look and do something about this? Some other countries already have run out of time and had to start early. Some have been more credible than others.

Clearly, on the policy side, it was mentioned to first take a hard look at the tax expenses, reduce expenses, then if need be increase taxes. In some cases, you need to go through all of them but overshoot, I would say, because right now we have this very perverse situation, which we have gotten into where every time we are chasing our tail, we are trying to make the markets happy, and we do something very dramatic, we think, and the next day the market says, "Well, I don't know."

Again, you have to go for the next Golden Rule. Our good Golden Rules are something we got into because we didn't do better before. Frankly, at least in the case of Europe, they do see one way out in order to gain credibility. Germany did it already two years ago. Spain is doing it now. Many of the other countries will have to follow suit.

Mr. Belka: We have had a very busy question and answer session. It proves the well-known fact that central bankers love discussing fiscal issues.

Mr. Cecchetti: Very briefly on the issue of the renegotiation of the social contract: My belief is the financial crisis has accelerated a problem that has been with us for several decades. It accelerated it by only a few years. In the end, the unfunded liabilities of advanced-country governments have been known to be anywhere from two to six times GDP for almost 20 years now, when the IMF started computing them. We should have been talking about that social contract for a long time. There is no way to avoid it, because this is all about government-supplied pensions and government-supplied medical care. In the end, that is what we are talking about.

Ms. Baicker: Just a brief response to a question about the bigger picture effects on growth of health-care spending. First order, when you are spending a sixth of GDP inefficiently, if you could increase productivity in that sector, that alone has economywide implications. Then more narrowly looking at the role of employer-sponsored health insurance in labor markets, it does interfere with the flexibility of U.S. labor markets. There is a phenomenon called "job lock" where people are hesitant to switch jobs if they are sick, because they will lose their health insurance. People then stay in the same job, despite being the least-productive workers at that moment. That interference has economywide ramifications.

It is not, I would emphasize, about the effect of rising health-care costs on the productivity of U.S. industry internationally, because fundamentally we think the cost of health insurance is passed from employers down to employees. Rather, to the extent it interferes with the allocation of labor across jobs most effectively, that exerts economic drag as well.

Mr. Chandra: The big cost of our current system is that, if you are a state like my state of Massachusetts, a third of all your government spending goes into health care. Some suggest half of it is waste. That is money that could have been used to finance education. We are after all going to stick these future Americans with the tax bills to pay for our health care. The real cost is spending on health care instead of spending on human capital, because we know that is the way to really get productivity moving in the country. So every dollar that goes into the proton beam is a dollar less for some school. That is the real cost.

Ms. MacGuineas: I'll just close by saying it is good everyone likes to talk about debt so much, because I have a feeling this is a theme we will be harping on for many, many years. While obviously I don't think we want to frontload our deficit-cutting too much, that is not the biggest worry I have. There is no way we are going to end up cutting debt by too much. We may get caught in a pretty tough cycle here.

This whole notion of outsourcing pieces of these tough decisions is interesting. It is something we will hear more about, because clearly so much of this is a failure of our political system to make the hard choices. We will start to see ways to move those decisions away from them. Maybe it doesn't have to be the Fed, but maybe we will have other institutions.

Finally, fiscal rules will come back: 1) because they sound easier than specific choices, but 2) they can be workable. I just hope we won't soon be looking at papers on what the tipping point for the actual full-blown fiscal crisis is, instead of the drag on economic growth. That's chilling.