FISCAL FINE PRINT
© Leo Haviland, 646-295-8385 February 7, 2012

"Dear Mister Fantasy play us a tune
Something to make us all happy
Do anything, take us out of this gloom
Sing a song, play guitar,
Make it snappy." Traffic's song, "Dear Mr. Fantasy"

A COVER PAGE

Political and economic policy generals have battled feverishly to resolve the ongoing worldwide financial crisis that emerged in 2007 and to restore adequate economic growth. They have won some important victories. Not only has the banking (financial) system held together. Sustained central bank easing around the globe has helped worldwide economies to ascend from autumn 2008/first quarter 2009 depths. Federal Reserve assistance- ground floor interest rates, two enormous money printing explosions, Operation Twist, and other liquidity-building measures- did not stand alone. Gargantuan deficit spending in the United States and elsewhere also has propelled recovery. Things have to be great, or at least very substantially improved, right? Underline the massive rally in the S+P 500. At around 1345 at the end of last week, the S+P 500 is almost double its March 6, 2009 low at 667. It neighbors the 5/2/11 peak at 1371. To some observers nowadays, the S+P 500's 5/19/08 final top at 1440 and perhaps even its earlier 1576 pinnacle (10/11/07) may not seem extraordinarily distant.

Sunny rhetoric from political representatives and trusty economic watchdogs can reassure nervous audiences, at least for a while. Bolstering economic confidence obviously tends to boost spending, especially by consumers, and thus aids recovery.

Unfortunately, gloom has not evaporated. Note the International Monetary Fund's World Economic Outlook (1/24/12). The WEO headlines "Global Recovery Stalls, Downside Risks Intensify". It states: "The global recovery is threatened by intensifying strains in the euro area and fragilities elsewhere. Financial conditions have deteriorated, growth prospects have dimmed, and downside risks have escalated." Perhaps such pessimistic concerns will fade, and maybe economic bears will be forced to retreat further.

DEFICITS- A CURRENT CONCLUSION

To create a sustained and substantial recovery, gurus and their audiences agree that much matters on the fiscal front. In the darker days of the economic crisis, most financial sentinels and their allies proclaimed that large sustained fiscal deficits were good (or at least acceptable, up to some point). Whatever have been the short term benefits of enthusiastic deficit spending campaigns in America and elsewhere, epic fiscal measures only shifted some of the debt (and leverage) burden from the private sector to the public one.

However, nowadays big sovereign debt generally is viewed as a problem. Most of the public hopes that noteworthy fiscal progress to reduce terrifying deficits has been made, is being achieved, or eventually (and soon enough) will be accomplished.

Deficit levels and trends intertwine with numerous other variables. On the fiscal policy front, much can change, and do so quickly. Situations vary between nations and regions.

Let's spend time surveying some fine print regarding the fiscal landscape, paying particular attention to Europe and America. At best, only limited advances have been made in recent wars against huge deficits. Actually, judging from their very modest results, these struggles to slash them look more like skirmishes than pitched battles.

DEFICIT HIGHLIGHTS

Digging into International Monetary Fund's "Fiscal Monitor" (January 2012, Table 1) unearths a detailed overview. **Even if the world fiscal situation has not worsened very recently, on balance it is not getting any better.**

The IMF's overall fiscal balances and gross debt statistics include not only those of the central (federal) government, but also those of other governmental entities. The world overall fiscal balance was a two percent deficit of GDP in 2008. It spiked to 2009's -6.7pc. For the next two years, it remained elevated, with 2010 at -5.5pc and 2011 at -4.5pc. Even estimates for 2012 and 2013 remain fairly substantial. They are above 2008's and higher than a three percent deficit level that some label as reasonable for a country in general. The 2012 fiscal deficit is -4.1pc, with 2013's at -3.4pc.

Thus world general government gross debt as a percentage of GDP jumped higher. It was 59.5pc in 2008. It charged up to 65.9pc in 2009, advancing to 70.0pc 2010. Perhaps so-called good news is that it only inched higher in 2011 (to 70.1pc), and that it allegedly will creep up only slightly for 2012 and 2013 (to 70.9pc for both years). Is going up a little really good news, though? Anyway, genuine bad news is that it is not going down in 2012 and 2013.

The gross debt versus GDP vista differs across regions. The general government gross debt in advanced economies was 82.0pc in 2008. Incidentally, this is not a low level in the view of many economic guides. It rose to 93.7pc in 2009, 99.7pc in 2010, and 103.5pc in 2011. It marches upward to 107.6pc in 2012 and 110.2pc in 2013. Significantly, no progress is being made in gross debt reduction versus GDP by the advanced economies category.

According to the IMF, United States general government gross debt as a percent of GDP soared from 2008's 76.1pc to 2011's 102.0pc. It reaches 107.6pc in 2012 and 112.0pc in 2013. What about the history of and forecasts for the Euro area? From 69.8pc in 2008, it inflated to 88.4pc in 2011. Despite austerity efforts, Euro area gross debt grows to 91.1pc in 2012 and 92.5pc in 2013.

The overall fiscal balance for the United States was -13.0pc of GDP in 2009, -10.5pc in 2010, and -9.5pc in 2011. Thus even in the economic recovery of 2010 and 2011, deficits were huge. Such deficit spending (intertwined with the Fed's assorted lax policies) surely assisted GDP growth. Anyway, the IMF indicates US fiscal deficits will stay high, with -8.0pc predicted for 2012 and -6.4pc for 2013. America's fiscal policies have played an even greater part than Europe in creating these high international gross debt percentages (especially within the advanced nations group). However, European ones are not trivial. Overall fiscal deficits in the Euro area have contributed to its growing gross debt versus GDP percentage. The Euro area deficit was -6.5pc in 2009. In 2010, it was -6.3pc, slipping to a still rather high -4.3 in 2011. The IMF believes Euro area deficits will subside further, to -3.4pc in 2012 and -2.9pc in 2013.

EUROPEAN DETAIL: THE NEW FISCAL TREATY

A Financial Times front page headlines the European Union's "tough fiscal treaty" (1/31/12; this refers to the "Treaty on Stability, Coordination and Governance in the Economic and Monetary Union"). **Many applaud this treaty for its alleged fiscal hard line. It indeed takes a step towards resolving Europe's sovereign debt and banking crisis, but a small step is not a giant leap. Despite the stagecraft of European leaders, the region's fiscal challenges are not near to being resolved.**

Treaty details probably will be fleshed out via negotiation and interpretation. Maybe the treaty will become more powerful. Also, arguably one needs to be a legal expert or political insider (or both) to completely comprehend this treaty wordplay, its likely application in practice, and related European laws.

Nevertheless, **a closer reading of the language of this proposed European treaty and Euro leader comments related to it indicate that less progress has been made on the European fiscal front by means of this treaty than many pundits preach. The treaty appears somewhat stronger than existing rules. However, its ambiguities probably will weaken it in practice. Its sanctioning process probably will not scare nations much either.**

Article 3, section 1 (part of Title III, "Fiscal Compact") speaks of "annual structural balance" and structural deficits for a given country, as well as "rapid convergence" toward a given "medium-term objective". What is this structural balance (deficit) and rapid enough convergence in practice? The time frame for this convergence is "proposed" by the Commission. Proposed is not the same as required, is it? The Commission gets to take into consideration "country-specific sustainability risks". Parties can "temporarily" deviate from their medium-term objective or the adjustment path toward it "only in exceptional circumstances". Treaty apologists may proclaim that structural balance is clearly defined. Yet national players may disagree (debate, negotiate) on what the structural balance is. Criteria for exceptional circumstances exist, but these are rather vague and matters of opinion. What are these country-specific sustainability risks, and what factors define them? The bottom line is that substantial flexibility of interpretation and application apparently exists within the treaty.

The treaty's preamble is no clearer. It speaks of monitoring "through the setting up of country specific medium term objectives and of calendars of convergence" for each Contracting Party, "as appropriate". What will be these objectives and what will be appropriate in a given case? And "sufficient progress toward the medium term objectives should be evaluated on the basis of an overall assessment with the structural balance as a reference." But what will be the structural balance and sufficient progress in a given case? How specific is "reference"?

Article 8 speaks of the ability of the European Commission and a Contracting Party to bring an action before European Union's Court of Justice against those supposedly in breach of the treaty. This court process will take time in practice. The wrongdoer must "comply" with the judgment "within a period to be decided by the Court". More room for flexibility. If a Contracting Party eventually decides that other nation has not "taken the necessary measures to comply", it "may" bring the case before the Court of Justice and request financial sanctions. This "may" not only leaves more time for fiscal delay (and negotiations), but also shows that the treaty may not be too fierce in practice. Besides, it will take time for the Court to reach a judgment.

According to the FT, in regard to this “German-inspired treaty”, Germany “was warned that there are limits to how much sovereignty governments could be expected to surrender for the sake of fiscal discipline.” In regard to a German proposal for the EU to control Greece’s budget decisions, the French president, Nicolas Sarkozy, underlined that this “’would not be reasonable, not be democratic nor would it be effective.’” Moreover, his views extend beyond Greece, for he added “There can be no question of putting any country under tutelage.” The French president mentioned he had “confronted” the German chancellor, Angela Merkel, with his views and that she had agreed with them. One therefore should wonder how strict this treaty will be in practice.

In any event, this fascinating treaty is not law yet. To come into force (on January 1, 2013 or earlier), the treaty must be ratified by 12 nations (“Contracting Parties”) whose currency is the Euro (Article 14, section 2). How easy will this ratification process be, and how soon will it occur? If it is not ratified by January 1, 2013, it arguably seems the treaty will not be able to come into force at all (Article 14, section 2). The FT notes that the French president claims he will not ask the French assembly to approve the treaty before France’s April 2012 presidential election. Sarkozy’s rival stated he will seek to renegotiate the treaty.

Moreover, Article 14, section 3 indicates the treaty does not cover those Euro members who have not ratified it (apart from governance meetings of Article 12). Of the seventeen members of the Euro area, some countries (particularly highly indebted ones) may not rush to ratify. However, there may eventually be some incentives. For example, getting assistance via the European Stability Mechanism (as of March 2013) will require ratification. However, compliance with the treaty may be delayed for a while by a “transposition period”. (See the preamble and Article 3, section 2).

The FT article remarks that Britain’s prime minister will take legal action if the new treaty “undermines British interests”.

AMERICA: DEVILS IN THE DETAILS

“Witchcraft” (songwriters Cy Coleman and Carolyn Leigh), sung by Frank Sinatra:

“What good would common sense for it do
Cause it’s witchcraft, wicked witchcraft…
It’s such an ancient pitch
But one I wouldn’t switch
‘Cause there’s no nicer witch than you.”

****

Nightmarish European sovereign debt and banking situations have distracted many from worrying as much about the US fiscal situation. Plus American politicians, though they still bemoan deficits and engage in partisan squabbles regarding how to fix them, are doing so with less fury and frequency lately. America’s charming legislators lifted the federal debt limit to $16.4 trillion in January 2012. They pushed modest national potential spending cuts beyond the 2012 election; they take effect (assuming they ultimately are implemented) in 2013 and several years thereafter.

US Treasury yields are at or close to rock-bottom levels for the first several years of the yield curve. Not only that, they probably are negative in real terms. Buried in the IMF’s Fiscal Monitor (1/24/12, Figure 2) is a portrait of negative returns from holding US debt (implicitly Treasury

debt). The Fiscal Monitor indicates the US in January 2012 has a negative real marginal interest rate of about a half of one percent (based upon its analysis of the yield curve and maturity profile; deflated versus inflation projections).

At the present time, does the US government's ability to readily sell US Treasury suggest an absence of fiscal difficulties? Probably not, fiscal challenges (problems) loom, even if some of their consequences are postponed for a while longer. Worldwide "flight to quality" concerns help sell US federal debt to domestic and overseas warriors. Even if the American Treasury these days can sell (relatively easily) most or all of its debt securities (to someone other than the Federal Reserve via money printing; QE2 ended in June 2011), many persons may be overly complacent regarding problems in the US fiscal realm. Not only might very low nominal (and negative real) yields become increasingly unattractive. Some safe haven purchasers of US Treasury debt may be acquiring these securities primarily because the US banking system (and those of other countries) has deposit insurance limits which fall far short of the buyer's cash capital. What if a bank goes bankrupt? Direct (clear) ownership of Treasuries may seem safer than putting money on deposit in some bank.

Monumental rallies in equity benchmarks such as the S+P 500 also help to shove deficit worries toward the background.

****

Though many states and municipalities face scary times, let's focus on the federal deficit. **The US fiscal situation remains fearful.**

The Congressional Budget Office (CBO) recently released "The Budget and Economic Outlook: Fiscal Years 2012 to 2022" (1/31/12). This lengthy study provides extensive details and forecasts. According to the CBO, there will be a $1.1 trillion deficit in fiscal year 2012, or 7.0 percent of GDP. Even though this slides about two percentage points from 2011's, it stands higher than any deficit between 1947 and 2008. (Summary, pp xi-xv). Something which seems less bad should not masquerade as being good.

Take a related perspective. In 2012, revenues are only 70.1pc of outlays (Table 1-2, p5). **Thus even after about three years into a recovery, budget discipline remains illusory.** Mandatory expenditures are 57.5pc of total outlays. Revenues equal 16.3pc of GDP, with outlays 23.2pc of GDP. (Table 1-3, p10).

****

In the CBO's baseline outlook, deficits drop. They average 1.5pc of GDP over the 2013 to 2022 span. Under this scenario, debt held by the public falls from about 75pc of GDP in 2013 to 62pc in 2022 (62pc still hovers above that for any year between 1952 and 2009). See also Table 1-3 for baseline details (p10). The baseline scenario envisages current law remains in place. Thus, for example, income tax cut provisions (dating from the time of the second President Bush) expire at the end of 2012. Also, the alternative minimum tax will capture more and more revenue.

Under the CBO's alternative fiscal viewpoint, deficits average a lofty 5.4pc of GDP over 2013-22. Debt held by the public climbs to 94 percent of GDP, the highest since after World War Two. (Summary, p xiii). This scenario extends (keeps) expiring tax provisions (other than payroll tax cuts), indexes the AMT for inflation after 2011, and assumes the automatic spending reductions of the recently-passed Budget Control Act do not take place. (See Table 1-6, pp18-19 and Table 1-7, p22).

****

Much on the economic front can affect deficit levels and trends. Yet the realization of the baseline scenario or something close to it will represent substantial progress on deficit reduction. Although what's good or bad on the deficit front is a matter of opinion, certainly the baseline outcome appears more fiscally "responsible" ("better over the long run for the country in general") than the alternative scenario. **But will the baseline outlook transpire? Probably not.**

Currently Republicans control the House of Representatives, Democrats the Presidency and Senate. Some split between the parties may continue after the 2012 election. This could create a legislative logjam, thus helping the baseline series of events to occur.

However, some approximation of the alternative fiscal scenario probably will evolve going forward after 2012, even if is a bit less extreme than that indicated by CBO fortunetellers.

First, recent budget discipline has been quite lax. Not only is a $1.1 trillion deficit in fiscal year 2012 a lot of money in arithmetic terms. At 7.0 percent of GDP, it is high relative to GDP and still fairly close to the deficit summits preceding it (2009 deficit was 10.1pc of GDP, 2010's 9.0pc, 2011's 8.7pc). Second, about zero progress in resolving very long run fiscal issues has occurred, despite longstanding warnings from a diverse array of policy observers. Even if fiscal policies enshrined in current law go into effect (baseline), major budgetary challenges persist over the longer term ("Budget and Economic Outlook", 1/31/12, p xiii, p24; see the June 2011 "CBO's 2011 Long-Term Budget Outlook"). Third, America arguably has developed a culture of debt (and consumption) rather than saving. Not only is current household indebtedness still high. Looking over the past fifty years, America has run very few federal surpluses. From 1961 to present, only five years of surplus (1969 and 1998-2001; see "Budget and Economic Outlook", Table F-1, pp132-33).

In addition, most political players (like the public) support the continued restraint on the reach of the alternative minimum tax via indexing it for inflation.

Also, many politicians in both parties, as well as many national and international economic wizards, believe that "sufficient" deficit spending is appropriate (at least for the near term) to help sustain "sufficient" economic growth. Although what is sufficient is debated, we hear hardly any talk about the merit of dramatic near term US deficit reduction, or the wisdom of America's having no deficits at all (or at least roughly the same number of surpluses as deficits). Moreover, when 2013 emerges, how many of the Budget Control Act's anticipated spending reduction will actually stay enacted?

And a crucial reason for the likelihood of something like the alternative fiscal scenario (and thus continued substantial federal fiscal deficits) is the enduring widespread popularity of tax cuts (and low taxes in general), especially income tax ones.

Importantly, President Obama is not talking about raising tax rates (or otherwise increasing tax burdens) except on a very small percentage of taxpayers. His remarks in his "State of the Union" and "Built to Last" (1/24/12) comments are worth stressing. In the State of the Union: "If you make more than $1 million a year, you should not pay less than 30 percent in taxes….In fact, if you're earning a million dollars a year, you shouldn't get special tax subsidies or deductions. On the other hand, if you make under $250,000 a year, like 98 percent of American families, your taxes shouldn't go up." In "Built to Last": the President advises listeners: "Make the tax code fairer and simpler for the middle class and make sure millionaires and billionaires follow the

Buffett Rule by paying at least 30% in taxes." "Built to Last" underlines the $250 thousand "income" level threshold.

Even though not all earnings come from wages, the President's political- and spending-orientation seems clear. This 98 versus two percent sermon echoes the 99 versus one percent rhetoric often heard around the globe over the past several months.

Though of course not all Republicans are alike, most probably are more hostile than the President (and Democrats in general) to tax increases. Who the Republican Presidential candidate will be remains to be seen, as is that party's ultimate election year platform. However, review the plan of the current frontrunner, Governor Romney. (See the Tax Policy Center, Urban Institute and Brookings Institution study of 1/4-5/12, quoted in the NYTimes, 1/19/12, pA15). The NYTimes says Romney's tax plan "calls for permanently extending the Bush administration's tax cuts, reducing the corporate income tax rate, and eliminating the estate tax".

The Tax Policy Center's analysis focuses on one calendar year, 2015. Romney (and other Republican candidates reviewed) may disagree with the Center's conclusions. However, the 1/5/12 analysis (p2) states: "The Romney plan would reduce federal tax revenues substantially." It adds that "on a static basis" there will be a $600 billion cut ("lower federal tax liability by $600 billion") for calendar year 2015. And "Relative to a current policy baseline, the reduction in liability would be roughly $180 billion in calendar year 2015."

The "static basis" envisages that existing laws stay in place (so Bush era cuts expire). Thus the static basis resembles the CBO's "baseline budget outlook". The Center's talk about the "current policy baseline" indicates that it is much like the CBO's "alternative fiscal scenario" Thus arguably the Romney plan is even more deficit-creating than the CBO's alternative fiscal scenario.

****

In "Built to Last", the President recalls his earlier plan to reduce the deficit by over $4 trillion over the next decade, including over $2 trillion already signed into law by the Budget Control Act. If he is reelected, it will be interesting to see if such cuts are proposed, or even occur (especially if the Republicans control at least one house of Congress). A fiscal crisis of course could motivate bipartisan efforts to substantially slash deficits.