EconoFact Chats: Economic and Political Fallouts from Debt Debacles

Adam Posen, Peterson Institute for International Economics

Published on 22nd January 2023

Michael Klein:
I'm Michael Klein, Executive Editor of Econofact, a nonpartisan, web-based publication of the Fletcher School at Tufts University. At Econofact we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein:
On September 23rd, 2022, Kwasi Kwarteng, who was then Britain's new Chancellor of the Exchequer, a position that is called the Secretary of the Treasury in the United States, gave a speech on the British government budget that promised a new approach for a new era. It was soon a new era for Mr. Kwarteng, who was sacked by Prime Minister Liz Truss on October 14th, after he spent only 39 days on the job. Prime Minister Truss soon lost her position as well, illustrating the political ramifications of fiscal policy. But not only do fiscal outcomes affect politics, politics affects fiscal outcomes as well. Witness the current debate in the United States about the debt limit and the deep concerns it has raised. To discuss the interplay of politics and fiscal policy, I'm pleased to welcome back to Econofact Chats Adam Posen, the president of the Peterson Institute for International Economics. The Peterson Institute is one of the preeminent think tanks in this country. Adam has served as its president since 2013. Before that, he served seven terms as a member of the panel of economic advisors to the U.S. Congressional Budget Office. He also served a three-year term on the Bank of England's rate setting monetary policy committee between 2009 and 2012, during the recovery from the financial and economic crisis. Adam, welcome back to Econofact Chats.

Adam Posen:
Michael, thank you for having me back on Econofact Chats. I'm really glad to be with you.

Michael Klein:
Well it's really good to have you back. Adam, let's start off with a softball question. Why are fiscal policy issues so politically fraught?

Adam Posen:
These are the issues, Michael, where governments express their values, who they're helping and who they're not. These are issues that are incredibly visible on the daily news, in consumer's pocketbooks but also in markets, because you have these government bond markets and exchange rate markets that trade on the basis of fiscal policy. And this feeds back on each other, so when people, as you've talked about on other episodes, have things like loss aversion, you change a policy, people can get very angry. Or you promise something and can't deliver, or have to stop it, people get very angry. This is high stakes.
Michael Klein:
So now another relatively softball question, at least it's a softball for you. How do the politics of fiscal policy affect economic outcomes?

Adam Posen:
Traditionally the worry from economists and political scientists is that elected officials try to buy constituencies off. They try to pass out goodies. Sometimes they pass out too many goodies at one time that they can't pay for, or that they time booms and busts to try to help them with elections. And all of these are economically inefficient. The amount of damage they do varies. You can have money that just gets wasted, and it's not the end of the world. But you can have money that's ill spent, that on the one hand deprives the society of spending on more important things. And you can have money or, for that matter, tax changes that persuade people you're not being responsible. In which case, generally investment climate gets worse. And in particular the interest rate you pay on government debt goes up if you convince markets, fairly or unfairly, that you're being irresponsible.

Michael Klein:
So paraphrasing that famous line from Casablanca, I'm shocked, shocked that there's politics going on here.

Adam Posen:
Robbers go where the money is, to paraphrase another famous line.

Michael Klein:
Adam, as a former member of the Bank of England's Monetary Policy Committee, I'm sure that you followed the events in Great Britain last fall very closely. Can you tell us what Chancellor Kwarteng was proposing?

Adam Posen:
Yeah. The then Chancellor Kwarteng and the then Prime Minister Truss came in and announced a very large set of spending to try to support households in the face of high energy costs. And that was on the order of 60 billion pounds or $65 billion. They also were going to cut the income tax rate in general by 1%, but at a time when you were spending more. But the big thing was, they were not going to raise corporation taxes, and leave them at the lowest rate in the G20. And they were further going to make a very visible cut in the marginal tax rate for the richest or the highest income people. People earning over 150,000 pounds would be reduced tax rate to 40% from 45%. But I think what was really important, Michael, was they did it in a way where they acted as though it didn't matter how they paid for it. Most British chancellors, most democratic G-7, G-20 governments, when you announce a big new package, you say, "okay, and here's why I think this is sustainable." They just went ahead and said, "we're not going to worry about that." And they ignored the budget process, and they just said, "this is the part we're doing."
Michael Klein:
They ignored the budget process. They sort of went about this in a backhanded way, right? Where they introduced this in a way where they didn't have to put down the numbers. Is that correct?

Adam Posen:
Yeah, and I mean we shouldn't look at this mechanistically. It's not like whatever the Congressional Budget Office in the U.S. or what's called the similar, what's called the Office for Fiscal Responsibility in the UK does in terms of evaluating budgets, nobody really believes literally that their projections are right. Because stuff happens. The economy goes up and down. Shocks happen, but you want a feeling that this has been reviewed. There's some belief that over time this will... ‘this’ being whatever budget proposal a democratic government makes, will have net positive effects on growth, net negative effects on the level of debt. And they just ignored that. They fired the senior civil servant at the treasury, which is basically the number-two person at the treasury. They put this out there without running it by the OFR, which is the UK version of the CBO. And they literally omitted any talk about payment or sustainability in their speech, except for some mumbles that were not very credible. So they essentially not just did a budget buster, but they did a budget buster in the most ostentatious, offhand way a major-economy government has done in a long time.

Michael Klein:
So what was the stated motivation for this policy, Adam?

Adam Posen:
It's very important, Michael, you say stated, because as you and I were joking a minute ago, there are all kinds of venal reasons why politicians might propose budget measures. But the stated reason was an extreme version of supply-side economics as used to be asserted in the early ’80s, 40 years ago under Thatcher and Reagan. The idea was that cutting the taxes on corporates, on high earners, would revolutionize and mobilize the British economy. And there is a fair point underlying their concerns, their stated concerns that since I left the UK, and this is not causal, the last dozen years productivity growth has been extremely flat and very poor, even compared to the other G-7 economies, including the U.S.. And so there is this need for something to change the trend. And so ostensibly Kwarteng and Truss were pursuing an agenda that was going to raise trend growth in the UK.

And in addition, they were going to do what they called supply-side measures in terms of creating some low tax investment zones, deregulating certain kinds of land reform, and development. And so implicitly they were saying this would pay for itself, because you make these huge budget and tax cuts, you would free the private sector. Of course for 40 years people have been saying that or longer, and it generally hasn't worked that way.

Michael Klein:
Well you said it's not causal that you left, and then productivity fell. But nobody has actually proven that, right, Adam?
Adam Posen:
Absolutely. Christmas cards cause Christmas, and I caused the productivity slowdown.

Michael Klein:
So there was a big fallout from the chancellor's speech, right?

Adam Posen:
Yeah. Immediately, interest rates spiked on British government bonds, including particularly the long bond. There was an amplifier of the fallout that, because the interest rates moved so high, so fast, a bunch of pension funds in the UK were caught short, because they had, for regulatory but also strategic reasons, projected needing very low rates. And so then they had to sell off bonds to get their portfolios back in order. And that further drove up interest rates and made a bit of a panic in the market. And then accompanying this panic, there was also a panic in the sterling market, meaning the great British pound declined quite significantly, much more than the euro against the dollar.

Michael Klein:
So that's a little bit of a puzzle, perhaps, because when I teach international economics, I say, when a country raises interest rates, its currency appreciates not depreciates. That is, it strengthens, not weakens. But that's not what happened in the UK when the interest rate spiked up. And I guess the reason is because of risk. Is that correct?

Adam Posen:
Yeah, and I'm sure you teach this later in the term, or in the second level course. It's all about the regime, as economists put it. It's about what kind of situation you're in. So if you think of Greece or Portugal during the euro crisis a dozen years ago, or you think of various Argentina at various points recurrently through history, I laugh bitterly. You have a situation where people lose faith in the ability of the government or the political system to deliver reasonable policies, that even if you make a mistake, you can get it back. And I think in the UK, we went suddenly to a period but culminating from Brexit, the UK's exit from the European Union, and the various turnover in conservative party governments over the last several years, combined with what Truss and Kwarteng did in terms of ruining the process that people lost faith. And so in a normal economy while functioning, what you said is of course right, that you drive up interest rates, the currency goes up. But the causality can go the other way. People are fleeing the economy. Capital is fleeing the economy. And so you have to put up rates to offset that. And that's what beset the UK economy through the '60s and '70s.

Michael Klein:
You're right. That's what I teach later in the course. The Bank of England, had to respond to that. Is this an example of what's called the fiscal dominance of monetary policy?

Adam Posen:
You can put it that way, although again, I think that's a fancy term that gets used. And I think it's more applicable to these extended periods like Latin American hyperinflations of the past, where
you have the government just printing lots of money, and people lose faith that the price level will be contained. I think this was a mini version, a warning shot of that. But so anyway, the Bank of England had to react, because the long-term bond rate was spiking. The pound was crashing. And if the Bank of England didn't react, you had two problems, well three problems. First, the pension fund sell-off would just keep feeding in on itself. Second that the markets would believe nobody was at home, that the Bank of England was essentially caving into...the independent Bank of England was essentially caving into the government. And third just that everybody would be comfortable with a spiraling interest rate, which was clearly not what you want.

Michael Klein:
So as I mentioned, Kwarteng had to reverse himself on this policy rather quickly. And then he was sacked by Liz Truss, who herself was removed as prime minister because of a vote of no confidence by the Conservative Party. What happened on that speech on October 3rd?

Adam Posen:
Well on that speech of October 3rd, there was announced a reversal of all the tax cuts, and Truss was booted very shortly afterwards. But I think the important thing was what happened after the speech. That the Conservative Party, Truss put in a new chancellor. And I'm not going to get into personalities about this person versus Kwarteng but that this person committed very ... I'm not trying to hide the person's name, Jeremy Hunt. But the new chancellor committed to doing things by the process, being transparent, letting the OFR review things, and talking about not cutting the top rate on taxes marginal top rate on taxes for corporations and high income individuals actually paying for things.

Michael Klein:
Adam, are you familiar with the song, "Alice's restaurant?"

Adam Posen:
I don't remember it well, I'm afraid.

Michael Klein:
Okay, well I guess I'm dating myself. But it's a song where Arlo Guthrie is talking about littering and going to jail. And then about two thirds of the way through the song he says, "this is what the song is really about. It's about the draft and the war in Vietnam." So switching gears here, sort of akin to what Arlo Guthrie did, what this podcast is really about, perhaps, is the potential crisis facing the United States with the debt ceiling vote. The experience in Great Britain shows the economic and political damage that can be done by fiscal policies that are seen as irresponsible. Can you explain what the debt limit is and why people are concerned about it?

Adam Posen:
I think you're absolutely right, Michael, that the direct relevance for the U.S., for your audience of the UK example is what we're playing with now. Or I shouldn't say we, what the Republican majority in the House of Representatives is playing with. So in a fit of political posturing, many years ago there was passed the law that the U.S. government has to announce a debt limit every
few years. And that's supposed to be the total amount of debt the U.S. government, the U.S. Treasury can issue. And then over time, whether because of growth or inflation or things like COVID, no matter what, within a few years the U.S. has to issue more debt. Which again, as I'm sure you've talked about, doesn't really matter what the debt total is. It matters what the debt total is in comparison to the size of our income, and what the interest rates are on the debt.

So my colleague, Olivier Blanchard has a new book out recapping all these issues. Anyway, so every few years there's this farce that the debt limit has to be raised. It doesn't mean anything, but people in Congress usually, I think almost always for the last 20, 30 years, Republicans say, we're going to take this hostage. We're going to posture that we care about debt, even though, when we've had Republican majorities, we've increased the debt. And we're going to use that to extract from the sitting president and the majority in the senate some concessions. And sometimes it's financial stuff. Sometimes it's about spending priorities. Sometimes it's something totally different. So right now the now Speaker of the U.S. House of Representatives, Kevin McCarthy had said he was going to not approve a debt limit as part of this political posturing. And then with the tenuous way he got elected speaker from the Republican majority, he got reinforced in this.

The upshot is, the U.S. is not the UK. But there is a commonality that, if the U.S. shows in a very persuasive way that our government cannot run a decent budget process, people will lose faith. And maybe the dollar won't crash the way the pound did, but probably interest rates would go up on long-term U.S. government obligations. There would be an interruption in growth, because various necessary government services would not continue, would be interrupted. There would be less resources available going forward because of the higher interest rates. And then for those of your listeners, and you've talked about thinking in financial terms, there would be likely a risk premium going forward on the U.S. government. Because if we cannot control our process, that's what happens.

Just one more point, if I may. I've done a lot of work on Japan in the past, which as your listeners may know, has a huge amount of public debt. And I kept telling people not to worry about it. And they always said, understandably, "Why? Why aren't you worried?"

And I said, well Japan, like the U.S., it's credible that the government could get it together to raise taxes, if it absolutely had to. And that's generally been the presumption about the U.S.. It's not that you have to have everything paid for this minute but that you have faith that the system will pay for things, if it has to. And when we have this kind of debt limit impasse, and this one looks like it's going to be pretty ugly, faith in that erodes both domestically and abroad.

Michael Klein:
I think it's important to note too that the debt limit is for money that's already been appropriated. It's not for future spending, right?

Adam Posen:
Good point. I overlooked that detail, which is quite important.

Michael Klein:
And another detail is that you said the Republicans failed to easily raise the debt limit. That's not true when there's a Republican president, is it?
Adam Posen:
Generally not. But as I recall, there was one point at which I think under Bush, where they threatened to play games. But generally they only do it when there's a Democratic president.

Michael Klein:
Yeah, Catherine Rampell of the Washington Post has an article about this. So the last time there was this failure to raise a debt limit was in 2011. And I remember this, well because I was in the U.S. Treasury at that time. And you've already discussed some of the fallout from financial markets that could happen. Does 2011 offer us a guide on what might happen now, or is this going to be even worse than what we saw back then?

Adam Posen:
Well as you experienced directly, Michael, and you're right, it just bears out exactly the general topic that we were talking about. We saw in 2011, we saw the bond rating actually of the U.S. be reduced from triple A, which is something that directly maps into demand for your dollar-denominated government bonds. Lower demand, higher prices, lower prices, higher interest rates. We saw the interest rates rise, and so we saw both the slowdown in the economy as a result of that, and the higher interest burden on the debt. I think, and [inaudible] at the Peterson Institute were writing about this at the time, just as you were working on the inside. We were trying to convince the people in Congress that this wasn't something to play with. The whole of U.S. financial markets or, for that matter, global financial markets depends on there being a very liquid, reliable U.S. Treasury market, ideally with low rates.
And so when you talk in legal terms about potentially defaulting on U.S. debt, which is in one sense unimaginable, but in another sense, if the debt ceiling is not raised, happens, then you're talking about repercussions around the world. Because then money, say, flows out of dollars, or the U.S. raises interest rates a lot to keep the money in dollars, in government bonds. And that leads to slowdowns around the world. And we have a lot of indebted countries now that can't really afford having long rates go up after U.S. short rates went up.

Michael Klein:
So you're painting kind of an apocalyptic picture. I know we're both hoping that it doesn't happen. But in your discussion of what happened in Britain and your wide-ranging discussion of what has happened in other countries, I think you've provided a really good background for understanding this, Adam. So thank you again for joining me Econofact Chats. I always enjoy our discussions.

Adam Posen:
Thank you for having me, Michael. This is stuff very important, and I'm delighted to work with you in getting this kind of discussion out there.

Michael Klein:
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