REMAPPING DEBATE
Asking "Why" and "Why Not"

Deficit-reduction advocates assess proper limits of bond market power

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May 11, 2011 — Despite frequent shorthand in the press that conflates the interests of bond investors and the public (or associates bond investors with the value of "prudence"), it is widely acknowledged — even among economists and experts who advocate for deficit reduction — that the interests of bondholders are not always the same as the interests of the public at large. Indeed, according to J.D. Foster, senior fellow in the economics of fiscal policy at the conservative Heritage Foundation, those interests are inherently distinct.

"There's never going to be perfect overlap," he said. "Citizens rely on government for a wide variety of things; bond markets simply are concerned about getting repaid with interest."

With that in mind, Foster and others said that, when crafting public policy, officials should always prioritize the interests of citizens over the interests of bondholders and potential investors.

"Presumably, that what a democracy is," Foster said. John Williamson, an economist and senior fellow at the Peterson Institute for International Economics, a centrist think tank, agreed, and added that he was growing increasingly concerned that officials are making policy decisions on the basis of the perceived interests of investors, perhaps at the expense of the public. Though Williamson noted that there are times when the interests of the two groups do overlap, "there is always a choice to be made," he said.

"One can't both be dictated to by the bond market and further the interests of the public," Williamson said. In a democracy, "to have the bond market dictate the position of government is unacceptable."

EXAMINING THE OPTIONS

Last week, in the wake of Standard and Poor's downward revision to its outlook on U.S. government debt, Remapping Debate began to examine the implications of policy makers being focused more on the question, "How well are we reassuring markets" than on the question, "How well are we serving the interests of our citizens." Did that focus reflect decision-making that, effectively, was not democratic?

This week, Remapping Debate reached out to several economists and other experts who are associated with calls for deficit reduction to get their views on whether and to what extent the bond market needs to be "heeded."

And we ask, "If the fears of higher interest rates or a debt crisis are rooted in the prospect that capital will flee from U.S. Treasury bonds, and if those fears are constraining the policy decisions available to elected officials? And are there ways to mitigate that danger without running the risk of compromising the interests of the public?"

Inflation expectations

Nevertheless, others asserted that there is some valuable information that policy-makers can glean from the bond market. Joe Minarik, a senior vice president at the Committee for Economic Development, a conservative think tank that describes itself a "business led public policy organization," said that, for one, the bond market is an important indicator of inflation expectations. Because bondholders are always concerned that an increase in inflation could devalue their investment, Minarik said, their decisions about whether to invest and what interest rates to demand from the Treasury Department are often a reflection of investors' expectations for the future inflation rate.

> "It definitely could be that if government officials were more concerned about inflation than they are about unemployment, then what's done for the benefit of bondholders has the potential to not be as good for Main Street." — Anthony Randazzo, the Reason Foundation

"The bond market is an average of what the world thinks," he said. "Markets are sometimes wrong because people's expectations are sometimes wrong, but if the bond market sends interest rates up, [it] is telling you that investors anticipate inflation. You've got to decide, 'Am I so confident that I should ignore the market, or should I pay special attention?'"

Minarik acknowledged that the federal government, particularly the Federal Reserve, spends a great deal of time trying to anticipate inflation in order to determine interest rates and craft monetary policy, and that the expectations of bondholders are not inherently any more valid than the Fed's expectations. He emphasized that when the expectations of the government and of investors conflict, it does not necessarily mean that the Fed should bring its expectations in line with those of bondholders.

And others pointed out that inflation is actually a perfect illustration of an issue on which there can easily be a divergence between the rate that bondholders and the public think is acceptable.

Anthony Randazzo, director of economic research at the Reason Foundation, a libertarian think tank, said that while bondholders will always like to see a low inflation rate, the Fed also has the power to reduce unemployment by buying large amounts of securities — including Treasury bonds — which can lead to lower long-term interest rates and more robust economic growth, though perhaps at the risk of higher inflation. (The Federal Reserve has recently announced that it is phasing out such a policy, prioritizing a fear of greater inflation over more aggressive steps to help reduce unemployment).

Additionally, many economists make a clear distinction between "hyperinflation" — a double-digit inflation rate — which would be harmful to investors and workers alike, and "moderate inflation" — a rate of about three to four percent — which could, in itself, boost the economy by alleviating household debt burdens. The Fed's current unofficial inflation target is below two percent.

"You always see this tension between inflation and unemployment in the Fed," Randazzo said. "It definitely could be that if government officials were more concerned about inflation than they are about unemployment, then what's done for the benefit of bondholders has the potential to not be as good for Main Street."

Investor confidence

Minarik and others said that the primary economic indicator that the bond market provides to policyholders is "investor confidence," or the likelihood that investors will refuse to buy Treasury bonds, demand a higher interest rate in order to do so, or sell the bonds they already hold.

Minarik said that the confidence of investors is something that policy-makers need to take into account because if federal debt is deemed a riskier investment, investors could demand higher interest rates and it could become more expensive for the government to borrow.

"The trust of the financial markets in the full faith and credit in the United States is an asset of all citizens," he said. "It provides us with an opportunity to borrow at low interest rates. If we decide that [continued borrowing and spending is necessary] to protect the immediate needs of our citizens, then we are consuming out of the asset of that trust."

Arnold Kling, an adjunct scholar at the libertarian Cato Institute, said that the bond market is actually a bad indicator of the likelihood of mass capital flight.

Others worried less about higher interest rates and more about the prospect of a "death spiral," in which confidence erodes quickly, bondholders rush to sell Treasury bonds, and the sudden rush of capital flight requires the government to default on its existing debt.

Arnold Kling, an adjunct scholar at the libertarian Cato Institute, said that the bond market is actually a bad indicator of the likelihood of mass capital flight. "If the bond market could predict death spirals, they would never happen," he said. "Nobody gets a warning when there is a debt crisis. I mean, we know, generically, that the U.S. is not on a sustainable path. But when will the market lose confidence? Nobody knows that. It will come without warning."

Kling said that, in his mind, the only solution was to "get control over the deficits." Several other people interviewed for this article echoed that viewpoint.

But if the fears of higher interest rates or a debt crisis are rooted in the prospect that capital will flee from U.S. Treasury bonds, and if those fears are constraining the policy decisions available to elected officials, are there ways to mitigate that danger without running the risk of compromising the interests of the public?

Capital controls

In a recent paper for the International Monetary Fund, the economist Carmen Reinhart, also a senior fellow at the Peterson Institute for International Economics, described a range of policy options that governments have utilized in the past to stem capital flight. Reinhart calls the employment of those policies "financial repression," a term that includes the use of low interest rates, taxes on financial transactions and savings, capital controls, and increased government regulation of the banking sector.

Reinhart points out that nearly all industrialized countries, including the United States, used some mixture of these policies during periods of high government debt since World War II. Her paper documents how such policies were effective not just in limiting capital flight, but also in actually reducing deficits, because low interest rates were often combined with moderate inflation, creating an effectively negative interest rate, in which governments earned money from issuing bonds.

> Carmen Reinhart points out that nearly all industrialized countries, including the United States, successfully used some mixture of "financial repression" policies — including capital controls — during periods of high government debt since World War II.

According to Reinhart, current economic conditions look strikingly similar to the period between 1950 and 1970, when many governments had incurred "debt overhangs" — or situations in which the high cost of a country's debt is combined with a decline in economic health.

"To deal with the current debt overhang, similar policies to those documented here may re-emerge in the guise of prudential regulation rather than under the politically incorrect label of financial repression" she wrote.

Controls of capital movements come in several different forms, from fixed rates of exchange on foreign currencies, to taxes on currency exchanges or other financial transactions, to caps or outright prohibitions on capital movements, such as those imposed by Iceland in 2008 in response to widespread capital flight following the financial crisis.

Kling and others were strongly opposed to the imposition of capital controls or other mechanisms to reduce capital flight in the U.S. That opposition was voiced on different grounds, the most prominent being feasibility.

Foster questions how the federal government could track financial transactions, which occur with the click of a mouse. Williamson argued, however, that though capital controls come with costs in infrastructure and labor, and though there is often "leakage," or capital movements that escape the notice of regulators, "that doesn't mean they are entirely infeasible or entirely useless" (see box on next page).

But Minarik pointed out that if the U.S. were to institute regulations that investors perceived as onerous, they would simply invest their money elsewhere in the future. Others, such as Michael Cheah, senior vice president of the investment bank SunAmerica Asset Management, said that capital controls could come with other costs, as well, stifling growth and innovation by making it harder for companies to gain access to financing.

Proponents of greater control over capital markets and movements have often proposed an international regulatory regime, or coordinated domestic regulations between several countries, to address these concerns. When Remapping Debate asked Minarik whether more coordinated international regulation could be a solution to the problems he brought up, he said that a coordinated regulatory approach by several countries was not politically realistic.

Cary Leahy, a senior economist at Decision Economics, a private investment research firm specializing in financial markets, agreed. “We can’t even drum up support in the United States for a tax on millionaires,” he said. But Leahy added that political frameworks have changed drastically in the past, and could conceivably change again. In the last three decades, he said, “the pendulum has swung to take a managed capitalist system and take the management out,” and it could still swing back to a system in which “the worst excesses of capitalism are controlled.”

Cary Leahy of Decision Economics noted that although some policy options seem infeasible in the current political environment, that environment has changed drastically in the past, and could change again.

John Williamson echoed that point and said that, while he sees a need to reduce the deficit and the national debt in the medium-term, he recognizes that significant cuts in deficit spending in the near future, while the economy remains fragile, could have disastrous effects.

“I suppose we’ve become accustomed to this world in which we can switch the locale of investments quite freely, a value that’s worth preserving if it’s feasible,” Williamson said. “But if the choice we’re looking at is between financial repression and austerity [in the near future], I would choose financial repression.”

And, he said, financial repression could potentially make officials less likely to defer to the perceived interests of investors.

Considering all of the options

Randazzo of the Reason Foundation pointed out that policy makers were not even considering capital controls and other methods of reining in the power of capital markets. Although he said that he would likely oppose further government interference in financial markets because of what he described as

the poor track record governments had in making appropriate and effective regulations in the past, he added that it is very important for officials to consider all of the policy options available to them.

“There are plenty of ideas that I personally think are bad ideas that deserve a public hearing,” Randazzo said.

Randazzo emphasized that all decisions about the debt and the deficit represent choices by policy makers. Williamson agreed and noted that all policy decisions come with potential costs and benefits; it was necessary for officials to judge their policies on the basis of how well they will serve citizens.

When asked if the lack of consideration some policies that investors objected to represents an undemocratic decision-making process, Randazzo said that it depends on the situation.

“If those decisions are not being talked about because Congressmembers don’t know about them, then it’s a failure of the intellectual community, not democracy,” he said. “On the other hand, if officials are just rejecting those options out of hand, then you might have a problem.”

“If policy makers — specifically those that are more inclined to capital controls and regulation — want to bring those ideas into the public debate, then we should talk about them now,” Randazzo went on. “It would be much better to examine all of the options now, so that in ten years we’re not in a situation where we’re looking back and saying, ‘Oh, if only we had talked about doing this back then.’”

Capital controls: how might they work?

Opponents of capital controls often argue that, as capital movements have become a more pervasive part of the economy — involving larger and more frequent transfers — controlling those movements is no longer technically feasible. But that argument has little resonance with many other economists, who say that the change is one of degree, not of kind.

John Williamson of the Peterson Institute for International Economics pointed out that financial institutions and firms already have to maintain records of transactions and monetary transfers, which means that an electronic “paper trail” of financial transactions already exists.

When governments institute controls on capital movements — deciding whether to tax or prohibit transactions of a certain size — they must first require firms to report some or all financial transactions, Williamson said. The U.S. already requires financial institutions to file a report for currency transactions of more than $10,000, and many other countries also require reporting of certain electronic transfers.

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Capital controls: how might they work?

Williamson noted that in the 1960s and ’70s the United Kingdom maintained a very comprehensive system of capital controls, limiting even the amount of money that families could take out of the country on vacation.

Monitoring the movement of capital in the U.S. would be labor intensive, and would require a significant investment in government infrastructure, Williamson said. Additionally, the government would have to invest in enforcement mechanisms. But, Williamson argued, those costs are not a reason to dismiss capital controls outright.

Opponents also cite the fact that, historically, capital controls have often been “leaky,” and Williamson agreed that, the stricter the controls are, the more firms feel an incentive to evade them. However, Williamson said, “we know that [all] people don’t pay [all] their taxes, but we nevertheless tax people.”

The issue, he stressed, would be designing a system of controls that are easily enforceable, and investing adequate resources into monitoring transactions and enforcing those regulations.

“There’s no inherent reason why you shouldn’t have reporting requirements even on minimal capital outflows,” Williamson said. “It’s simply a matter of increased reporting and enforcement costs, which should figure into a cost-benefit analysis.”

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