DOC. N.º 52

BloombergBusiness

U.S. 'Fiscal Hawks' Mimic France: Peter Boone and Simon Johnson

November 1, 2010 — 1:00 AM GMT The sharp budget cuts announced in the U.K. last month have people asking: could the U.S. soon take similar steps?

The two countries share some key problems, including the aftermath of a housing bust, overreliance on high-risk financial services, and government debt levels approaching the danger zone. Self-proclaimed fiscal conservatives also are likely to make a strong showing in midterm elections.

But there is a world of difference between the nations' fiscal situations. The British, who are front-loading their cuts and may be overdoing it, are explicitly recognizing the extreme damage and future dangers to society inherent in their banks.

In contrast, our fiscal conservatives are much more French-like than British. Like President Nicolas Sarkozy, we have some politicians willing to make a fuss about tinkering around the cosmetic edges of our persistent deficits, but no one is ready to address our core issue: the U.S. financial system blew itself up, leading debt relative to gross domestic product to soar by 40 percentage points, and now is poised to do the exact same thing (or worse) again.

The macroeconomic trajectory in the U.K. is undeniably bad. The budget deficit was 11.5 percent of gross domestic product last year, with general government debt rising from 44 percent of GDP in 2007 to 80 percent in 2010. The heart of the country's vulnerability lies with what used to be thought of as an advantage -- London's status as a financial center.

Bad Bets

British banks became large relative to the economy, mostly because of financial globalization, and then collapsed; total assets reached more than six times GDP and the largest bank, Royal Bank of Scotland, had a balance sheet that was almost 1.5 times the size of the economy. (In Iceland, a country completely ruined by its banks, financial sector assets peaked at around 12 times GDP.)

The bust after their disastrous bets on U.S. and U.K. real estate pushed the country into deep recession and increased the budget deficit as tax revenue fell and government spending increased, partly driven by unemployment insurance payments.

At some level, the electorate and political elite get this. Britain's coalition government isn't just cutting the budget deficit; it is also conducting a far-reaching review aimed to reform big banks and end the dangerous boom-bust-bailout cycle. Even the Bank of England seems to be strongly on the side of centrist reformers now in power.

This fiscal adjustment will be painful; a right-leaning cabinet has no qualms about pushing the costs of fiscal adjustment onto relatively poor people.

Preemptive Action

But the framing of this choice has been handled with admirable cynicism. If the British stick with their previous path of budget deficits and the world doesn't get better, the continued buildup of debt will lead to a major calamity. If so, the U.K. would face a crisis, forcing even more drastic budget cuts at an ugly time. Guess who would pay for that?

Since the U.K. isn't facing an immediate fiscal crisis, it is acting in a preemptive manner.

In contrast, what do we see in the U.S. political debate? Prevarication. The Obama administration, the Federal Reserve, and the Republican Party are curiously silent on measures that would really reduce the political power of our largest banks and ensure that creditors and shareholders -- not taxpayers -- bear the costs when global megabanks fail again.

People who call themselves fiscal conservatives propose either raising taxes or cutting non-security discretionary spending -- actions that are trivial relative to the scale of deficits. This is no surprise; the U.S. can borrow at near- record low interest rates.

Parallels With France

Americans like to think of themselves as very un-French, but the U.S. has exactly the same problem as France: entrenched interests that block any discussion of real reform.

In France, it's the unions protesting any adjustment to pensions. In the U.S., it's powerful and far less visible corporate interests that fended off any attempt to make banking sounder -- the financial industry lobby essentially defeated all attempts to make big banks smaller or substantially safer.

France suffers from a complete lack of social recognition that tough measures probably need to be taken. Its budget deficit is 8 percent of GDP, its debt-to-GDP ratio is 82 percent. Its society is aging, putting more pressure on the retirement system. The U.S. is in very similar shape -- with the most ironic difference being that big banks have less political power and thus pose less danger in France.

Most likely France and the U.S. will muddle through until investors grow tired of the risk or the banks blow themselves up again -- or both. Then the question becomes: who bears the cost of the necessary fiscal adjustment?

(Peter Boone, a research associate at the London School of Economics' Center for Economic Performance, is a principal in Salute Capital Management Ltd. Simon Johnson, a professor at Massachusetts Institute of Technology's Sloan School of Management and former chief economist of the International Monetary Fund, is co-author of "13 Bankers: The Wall Street Takeover and the Next Financial Meltdown." The opinions expressed are their own.)

• France • Peter Boone • Budget Deficit • GDP

Four OPEC representatives said they hadn't heard of any plan for talks. One Gulf member said de facto leader Saudi Arabia had no proposal to trim production by 5 percent, after Interfax reported the country had suggested such a cut at previous OPEC meetings, citing Novak. The minister said Russia would be willing to discuss output with OPEC, according to the news service.

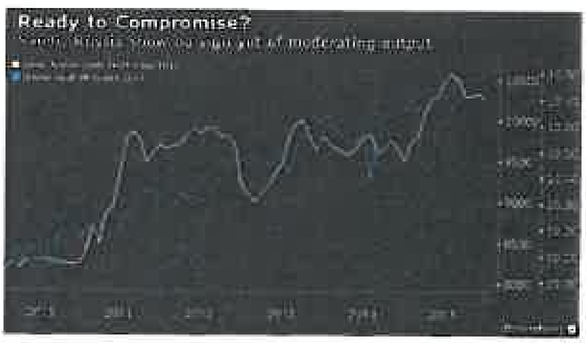
"It's possible that Russia could be testing the waters to gauge how OPEC members would respond to the idea of cuts," said Jason Bordoff, director of the Center on Global Energy Policy at Columbia University and a former senior oil official at the White House.

Brent oil on Thursday rose as much 8.3 percent after Novak's comments were reported before paring its advance to close at $33.89 a barrel, a three-week high. Prices on Friday extended gains, rising 0.9 percent to $34.18 as of 9:14 a.m. Hong Kong time.

Strained Finances

Until this week, Russia, which relies on energy for more than 40 percent of its budget revenue, had repeatedly stated its goal of keeping crude production stable even as prices tumble. Still, this month's price slump to a 12-year low has put the country under increasing financial pressure. The Finance Ministry says the nation's budget deficit, already at a five-year high in 2015, may widen this year as the rout deepens.

There are significant obstacles in the way of an agreement with the Organization of Petroleum Exporting Countries. Saudi Arabia is keen to defend market share and Russia's inability to cut production in winter months makes coordination difficult. Russia's oil output is set to reach a post-Soviet record of 10.89 million barrels a day in January, according to Bloomberg calculations based on Energy Ministry data.



The two countries' opposing views on Syria, where Russia is President Bashar Al-Assad's closest ally and Saudi Arabia seeks his removal, present another diplomatic obstacle.

Khalid Al-Falih, the chairman of state energy producer Saudi Arabian Oil Co., signaled last week in Davos, Switzerland, that the kingdom would persist with its policy of maintaining production. Global oil markets are in the process of re-balancing and a price recovery is "inevitable," he said.

Saudi Proposal

Russia's Novak said Thursday in St. Petersburg that Saudi proposals for a cut of as much as 5 percent at previous OPEC meetings related to crude-producing nations in general, not focusing on Russia, Interfax reported.

When asked if that proposal remains for a proposed meeting with OPEC in February, he declined to comment, saying, "that is exactly the subject of discussion." OPEC's next scheduled meeting is in June.

With the organization effectively abandoning its output ceiling in December, Russia pumping at record levels and U.S. shale fields proving more resilient than forecast, the global surplus has continued to swell and prices have continued to fall.

Read this next

- Saudi December Net Foreign Assets Drop More Than $19 Billion
- Russia Ready to Discuss Oil Cooperation With OPEC, Interfax Says
- Oil Pares Gains as OPEC Delegates Temper Russia Meeting Talk

• Russia • Oil • Energy • Saudi Arabia