Three Myths About the Sovereign Debt Crisis and Parallels to the US

Macro Panel
Sovereign Debt: A Cause for Concern?
2011 Financial Markets Conference
Navigating the New Financial Landscape

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Myth No. 1
The Sovereign Debt Crisis Was a Result of the Financial Crisis

• In Europe the countries with the most severe financial problems did not expend resources combatting the financial crisis

• The major commitments of funds were by central banks both in the UK and by the ECB
Myth No. 2
The European Financial Rescue Packages

• The European Debt Problems Were Not the Result of Having to Bail out Banks or Other Financial Institutions.
  – The main problems were persistent fiscal deficits
  – Over-commitment to labor and unions
  – Spending beyond means
Myth No. 3
The Way Out of the Crisis is Through More Spending

• We have seen questions raised about the multipliers to federal spending
• There is little evidence that there was other than a one for one substitution of government for state and local debt financing during the rescue period
• Uncertainty seems to be rule of the day.
Parallels Between the US and Europe

• Are there parallels between the US and European Fiscal Problems?
  – Many of the states in the US are experiencing fiscal deficits like the European countries
  – The deficits result from over-commitment of funds, especially to government employees and retirees.
  – Tax revenues are unreliable –
    • In the US tax revenues depend largely upon individuals, sales taxes and property taxes
    • In Europe, the primary tax tool is the VAT
    • When spending slows, so do VAT collections
  – Borrowing has become extremely costly
  – Bankruptcy and debt restructuring seems to be off the table for the moment
  – States and EU countries have begun adopting austerity programs
Differences Between the US and Europe

• The US has a federal fiscal deficit problem in addition to state and local government fiscal problems
• The US has a much lower costs of debt now
• The ECB has bought up sovereign debt whereas the Federal Reserve has not purchased debt of the states or local gov’ts
• The US federal debt to GDP ratio is approaching 10%, the largest since WWII, but substantially lower than that of Japan for example.
• Europe has no federal taxing authority so it must rely upon member country contributions to support countries with fiscal difficulties
Figure 3:
Thus Far 44 States are Anticipating Shortfalls in the Coming Year

Source: CBPP survey

Center on Budget and Policy Priorities | cbpp.org

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Figure 1:
Largest State Budget Shortfalls on Record

Total state budget shortfall in each fiscal year, in billions

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*Reported to date.
**Preliminary

Source: CBPP survey, revised March 2011.