(Ackermann)

Remarks at dinner honoring Joe Ackermann
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The Budget Deficit of the United States and the Current Account Deficits of the Eurozone Latin Countries

Thank you. It's a pleasure to be here in Frankfurt and a great honor to join in this celebration for our friend Joe Ackermann.

I have known Joe for many years and always look forward to the occasions when we meet.

Joe is a remarkable man in many ways. When I think about him, I realize that there isn't just one Joe Ackermann. There are at least four Joe Ackermanns.

There is the Joe Ackermann who headed Deutsche Bank, the most important bank in Germany and in Europe and one of the small group of leading banks of the world. Joe joined Deutsche Bank in 1996 and after just ten years became Chairman of the Board of the Management Committee. Joe transformed Deutsche Bank, starting with the investment banking activities, into the modern global institution that it is today.

There is also the Joe Ackermann who served as a director of several other leading companies, helping them to achieve greater performance, greater efficiency, and greater shareholder value.

There is the Joe Ackermann who headed the Institute for International Finance, strengthening its role in coordinating the financial institutions of the world as they dealt with the financial crisis of 2008, the Greek defaults, and the problems of government regulation of the financial industry. As someone who has attended meetings of the IIF I have always been impressed with Joe's style of leadership of this important international group.

I could continue the list, mentioning Joe's leadership in the support of cultural activities, his marriage to Pirkko, his intellectual contribution at the Bilderberg meetings, and even his early performance in the Swiss army reserves.

But closest to me is Joe Ackermann, the economist, who received his PhD in economics in Switzerland. Whenever I meet Joe and we talk about what is happening in Europe or elsewhere in the world, it is easy to see that he is not just a wise and experienced banker but someone who also understands the working of the global economy in a deep professional way.

Perhaps that is why Joe asked that I devote my remarks this evening to some of the economic problems confronting the United States and Europe.

More specifically, I will focus on the two current problems that worry me most: the budget deficit of the United States and the current account deficits of the Eurozone Latin Countries. After my remarks, I will look forward to your questions.

I'll start with the United States.

(The United States)

In the last few years the United States experienced an explosive increase in the annual government budget deficit and in the size of the national debt. The budget deficit went from $160 billion or 1.2 percent of Gross Domestic Product in 2007 to more than $1 trillion and 7.3 percent of GDP in the current year. The debt went from 36 percent of GDP in 2007 to 73 percent just five years later.

The greater deficit is not due to increased defense spending or higher interest costs. Defense spending is up less than one half a percent of GDP since 2007, from 4.0 percent of GDP then to 4.4 percent in 2012. The interest on the government debt is actually a lower share of GDP now than it was in 2007. Although the weakness of the economy depresses tax revenue and increases transfer payments, the IMF reports that the cyclical component of the deficit is just 2 percent of GDP. That's consistent with the projections of the Congressional Budget Office that even when the economy returns over the next decade to full employment -- basically an unemployment rate of 5.5 percent – without significant reforms the deficit would still be about 6 percent of GDP.

Why has this happened? The principal reasons for the rise of the fiscal deficit are new and expanded government programs, tax cuts, and the increased cost of the Medicare program of health care for seniors. Looking further ahead, the deficit and debt will grow rapidly even if there are no new programs or tax reductions because of the rising cost of Social Security pensions and of government health benefits. The cost of government health benefits for seniors and low-income families is expected to rise by 2 percent of GDP over the next decade and to rise by 5 percent of GDP over the next 25 years.

With no change in policy, the national debt will continue rising from 36 percent of GDP in 2007 to 73 percent this year and to 94 percent of GDP in 2022, and will then continue to rise after that.

The large national debt is a major problem for at least four reasons.

First, paying the increased interest on the national debt requires more tax revenue and those higher taxes hurt the economy. An increase in the debt from 40 percent of GDP to 90 percent, i.e., an increase in debt equal to 50 percent of GDP, and a five percent interest rate on government debt implies an extra tax of 2 ½ percent of GDP, an amount equal to about 25 percent of the total personal income tax revenue.

Taxes on personal income reduce incentives and therefore economic output. Individuals are worse off not only because they pay the extra tax but also because the higher tax rates discourage effort and cause other distortions.

Higher taxes on business profits reduce incentives to invest and to produce and drive businesses overseas.

The second reason why the increased debt is a problem is that the majority of the U.S. government debt is now held by foreign investors, primarily in China and Japan. Paying interest on that debt requires transferring output to foreign investors rather than consuming or investing it at home. And to earn the funds to make those payments the prices of U.S. goods must be reduced directly or through the exchange rate, giving Americans less for our output and making imports more expensive.

The third problem of the larger national debt is that it crowds out private investment, therefore reducing productivity and real incomes. Although this crowding out traditionally occurs through high interest rates, it now happens because the fear of higher taxes in the future discourages current investment.

Finally, a large debt reduces the flexibility of the U.S. government in future emergencies, including the possible need for increased military spending or the use of budget deficits to stimulate economic activity.

So the rising deficit and debt are indeed serious problems. What can be done to reduce the future deficits and reverse the rise in the national debt?

It is useful to remember that the United States lowered its debt to GDP ratio from 109 percent at the end of World War II to just 46 percent in 1960. It did this by keeping the total nominal debt constant -- balancing deficit years with surplus years – while real GDP growth of 2.2 percent and inflation of 3.3 percent caused the GDP to rise 133 percent over those 15 years. We cut the deficit to GDP ratio then and we can do it again if we can eliminate the future budget deficits.

Reducing budget deficits and achieving a balanced budget requires slowing the growth of the transfer programs to middle class seniors, the Social Security pensions and Medicare benefits.

Reducing the Social Security benefits that are projected in current law used to be considered politically impossible. I think that is no longer true and that slowing the rise of Social Security benefits as part of an overall budget deal is actually likely to be achieved during the coming one or two years. President Clinton, President Bush and President Obama have all warned the American public that some slowing of benefit growth will be necessary. Presidents Clinton and Bush actually developed detailed plans for doing so.

President Obama said, in his first State of the Union speech, that Social Security needs to be changed and he indicated a variety of changes that he would not approve – including cutting benefits for current retirees, cutting benefits for the truly needy, and financing the guaranteed benefits with stock market investments. Those exclusions leave lots of room for slowing benefit growth for future retirees above the lowest income level and using personal retirement accounts to supplement guaranteed benefits.

Slowing the growth of Medicare and other government health programs is even more important for deficit reduction. President Obama and Governor Romney have both indicated that that must happen. President Obama hopes this will occur through the effect of the Obamacare legislation on the way that services are delivered but, if that fails to slow the growth of spending, an administrative board created by the Obamacare legislation will be given the power to reduce payments to providers and probably to limit the scope of care. Governor Romney proposes a different approach based on giving all seniors vouchers with which to buy insurance or pay to participate in Medicare, adjusting the value of the voucher for the income and age of the individual. This has the advantage that individuals can supplement their vouchers if they want more expensive policies.

Controlling the cost of government health and retirement benefits is necessary, but it is not enough. Returning to a balanced budget will require additional tax revenue. Fortunately, that does not mean higher marginal tax rates on individuals or companies.

The key to raising revenue without increasing marginal tax rates is to limit the special provisions in the tax code, the so-called tax expenditures. Let me explain. If I buy a solar panel for my house or a hybrid car, I get a tax credit. If I pay more mortgage interest, I get a larger tax deduction. These represent government spending every bit as much as they would if the government sent me a check.

Many Republicans in Congress say that the deficit should be reduced by cutting spending and not by raising taxes. But when we consider tax expenditures, the distinction between cutting spending and raising taxes is a false dichotomy. Cutting tax expenditures is really cutting spending even though the budget improvement shows up on the revenue side of the ledger.

When I explain this to my Republican friends I am finding an increasing willingness to accept this argument and therefore to consider raising revenue by limiting tax expenditures, especially if it is part of a broader tax reform that also lowers marginal tax rates.

The practical problem is therefore how to limit these tax expenditures when every major form of tax expenditure has its fervent defenders. Limiting the mortgage deduction or the deduction for local taxes or the exclusion for employer paid health insurance would be strongly resisted.

So here is my suggestion for a practical way to limit tax expenditures: Let everyone keep all of his deductions and exclusions but put a limit on the total amount of taxes that individuals can save in this way. That limit could be set as a percentage of the individual's total income, i.e., of what US tax law calls Adjusted Gross Income.

Individuals would take their total deductions and special exclusions (like employer payments for health insurance), multiply that by their marginal tax rate, and compare the resulting tax saving to their adjusted gross income. If it exceeds the allowable limit, they would add the excess amount to their tax liability.

I have found that this idea of an overall cap on the use of tax expenditures appeals to the individuals and to the lawmakers with whom I have discussed the idea. It can raise a great deal of revenue that can be used to reduce the deficit and to finance marginal rate reductions.

For example, a limit on using tax expenditures to reduce tax liabilities equal to 2 percent of adjusted gross income would raise more than $250 billion a year at current income levels. That would reduce future annual deficits by more than two percent of GDP causing the future ratio of debt to GDP to decline.

There are of course a variety of other ways to put an overall limit on each individual's use of tax expenditures. And while there is no guarantee that this approach will find enough political support, I think it offers a useful and promising way to deal with our difficult fiscal problem.

EUROPE

Let me turn now to the problems of the Eurozone. I will confess that I have never been enthusiastic about the euro although I strongly favored the creation of the European Union. Even before the creation of the euro, I wrote articles explaining why imposing a single currency on a heterogeneous group of European countries would create significant economic problems.

The single currency means a single monetary policy and a single exchange rate, neither of which would be appropriate at any point in time for all the Eurozone countries. The United States can function with a single currency despite regional differences in economic conditions because of geographic mobility and the large cyclical net transfers to and from Washington. In Europe, differences of language and culture limit the geographic mobility of the workforce. Concerns about national sovereignty and national loyalty prevent the kind of budget arrangements that facilitate transfers in the United States.

An even more difficult problem is that with a fixed exchange rate there is no mechanism for adjusting the trade balances of the member countries. Differences among the Eurozone countries in productivity growth rates and in the rate of wage increase cause differences in international competitiveness and therefore in trade and current account balances.

Defenders of the single currency argued before the euro began that these differences in productivity and wage growth would not persist after the creation of the euro. The mechanism that would cause that convergence of productivity trends and wages was never explained. And in the end it never happened, leaving large differences in competitiveness and in current account balances. As you know, Germany has a current account surplus of about $215 billion while the rest of the Eurozone has a current account deficit of $140 billion.

Although productivity and wage trends did not converge, there was a rapid convergence of long-term interest rates as inflation came down in previously high inflation countries. Governments took advantage of the reduced interest rates to increase their borrowing and spending. Individuals also responded to the lower interest rates by increasing mortgage borrowing that financed a housing boom.

Surprisingly, international bond markets did not respond to the increasing national debt or to the increasing volume of mortgage debt in bank portfolios. Differences among Eurozone sovereign bond interest rates were very small, an implicit assumption that no country could default and that there was no exchange rate risk since no country could devalue.

All of that changed in early 2010 when Greece acknowledged that its fiscal situation was much worse than it had previously admitted. That was a wakeup call to the global financial markets. Investors focused on sovereign debt ratios and the capital adequacy of commercial banks.
The risk of sovereign defaults and of possible departures from the euro caused interest rates to rise sharply in Italy and Spain as well as in Greece, Portugal and other peripheral countries.

All of these countries now face five related problems: large fiscal deficits; the high interest rates on sovereign debt; inadequate bank capital; the lack of economic growth; and large current account deficits.

I emphasize that these are interrelated. The primary budget deficits raise interest rates and the higher interest rates contribute to the overall fiscal deficits. The high interest rates also reduce the value of the bonds held by banks and therefore of the banks' capital. The banks turn to their governments for capital and to assist depositors, adding to fiscal deficits. Fundamental structural problems in labor markets and with government regulation slow the potential rate of growth while the tax increases and spending cuts designed to reduce the fiscal deficits push the economies into recession. The slow growth of productivity and the rigidity of wages reduce international competitiveness and cause persistent current account deficits.

This complex set of problems can only be tackled by each individual country. There is no Eurozone solution. The fiscal compact lacks the teeth to compel the targeted reductions in deficits and declines in debt ratios. The idea of a banking union is not likely to advance beyond some centralized supervision of national banking authorities.

Italy has made substantial progress under Mario Monti. Slowing the growth of pension benefits and increasing real estate taxes has reduced the projected deficits. The International Monetary Fund projects that, on a cyclically adjusted basis, Italy will have a budget surplus in 2013. Unfortunately, since Italy will remain in recession next year, its actual deficit will still be positive, adding to the national debt.

The situation in Spain is not as good. Despite cuts in government spending and increases in taxes, the cyclically adjusted fiscal deficit is still projected by the IMF to exceed 3.2 percent of GDP in 2013 and 2.5 percent in 2015. Spain also needs to tackle the constitutional problem of its semi-autonomous regions.

Mario Draghi's plan to buy short-term bonds of Italy and Spain has been very successful in reducing rates on their sovereign debt, including the interest rates on longer term bonds. But it is a risky strategy that could get in trouble if Italy and Spain refuse to apply for the credit lines and don't have explicitly approved conditionality. And even if they do so, serious problems could arise if either country strays from their promised conditions, forcing the ECB to choose between letting interest rates rise or continuing to buy Italian and Spanish bonds despite their lack of policy conformity.

But if all goes well, Italy and Spain will achieve economic recovery and register budget surpluses. That will mean that their national debts are declining even if they have not achieved faster economic growth. Global financial markets will then cease to worry about the risk that they will default or leave the Eurozone.

But even if that optimistic scenario does come to pass, the current account deficits will remain. Italy, Spain and France all have current account deficits equal to two percent or more of their GDP. As they come out of their cyclical recessions, incomes will rise and that will lead to increased imports and even larger current account deficits. Those deficits must be financed by net inflows of funds from other countries.

If Italy, Spain and France were not part of the Eurozone, they could allow their currencies to devalue. The weaker currencies would lead to increased exports and reduced imports, eliminating their current account deficits. The increase in exports and the shift from imports to domestically produced goods and services would also strengthen their economies. That would reduce their fiscal deficits by causing tax revenue to rise and transfers to decline. And a stronger economy would help domestic banks by reducing potential bad debts and mortgage defaults.

But of course Italy, Spain, and France are part of the Eurozone and therefore cannot devalue. That is why I believe those countries and the Eurozone more generally would benefit from an overall decline of the euro. Although a weaker euro would not increase their competitiveness relative to Germany and other Eurozone countries, it would improve their competitiveness relative to all those countries that do not use the euro. If the euro falls by 20 percent or 25 percent, bringing it close to parity with the dollar and weakening it to a similar extent against other currencies, those three economies would see their current account deficit shrink and their economies strengthen. German exports would also benefit from a weaker euro, strengthening overall economic demand in Germany.

It is ironic that the ECB strategy to prevent a collapse of the euro by offering to buy Italian and Spanish debt has had the effect of exacerbating the current account deficit problem by raising the value of the euro. Perhaps that is just a temporary effect and the euro will decline when the global financial markets recognize that a weaker euro is necessary to cure the current account deficits of the Eurozone's three major Latin nations. If not, finding a way to talk the euro down will be the next challenge for the European Central Bank. I hope it succeeds.

I will stop there and look forward to your questions.

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