The Financial State of the Union

Lawrence Goodman
President – Center for Financial Stability

Cosmos Club
Washington, DC
September 20, 2012
Contents

I. Global Macro Themes
II. Deficits and Debt
III. It's the Principal that Matters!
IV. “Nontraditional” Monetary Operations
V. Implications for Reserve Currency Status
VI. Concluding Thoughts / New Policy Strategies
World Trade: Extreme Policy Response Limits Duration of Recession… *Distortions Remain*

Source: IMF Direction of Trade Statistics and Center for Financial Stability.
Spectrum of Fundamental Drivers:
Why Advanced Economies look more like Emerging Markets.

Advanced Economies  Middle Income Emerging Markets  Fragile States

More strictly  **ECONOMIC** analysis

More strictly **POLITICAL** analysis

Economics  Politics
Weak, Fragile and Volatile Economic Recovery

Weaker, fragile and volatile recovery: Q3 2009 - present

Deeper and longer recession: Q3 2008 - Q2 2009

Source: Bureau of Economic Analysis and Center for Financial Stability
Cumulative Deficits in Deep Downturns, % of GDP

Fiscal Stimulus and Capacity to Expand

It’s the Principal Matters!!!

Despite legitimate concerns regarding the budget deficit, large refinancings of debt represent an equally severe – yet lesser known challenge. The experience of emerging markets and some advanced economies suggests that…it is the repayment of principal that often triggers a crisis rather than simply the size of the debt or deficit.

USG Debt Maturities Spike in Coming Year

Note: Interest bearing public debt held by private investors.
Although US public debt-to-GDP was higher after the post-WWII period, the profile of maturing obligations was much safer!

More Dangerous Treasury Debt Profile

Note: Interest bearing public debt held by private investors.
Limits to the Fed’s Quantitative Easing (QE)

With thanks to William Barnett, Director of Advances in Monetary and Financial Measurement and Jeff van den Noort, Chief Technology Officer at the Center for Financial Stability.

Source: Federal Reserve, other official bank rates, and the Center for Financial Stability.
Federal Reserve Funding of Fiscal Deficit
Net Purchases of Treasury Securities by the Fed, %

Fed purchases of Treasury bonds distort market relationships.

Source: Federal Reserve, Flow of Funds Accounts and the Center for Financial Stability.
Policy Distortions: Risks for Markets and Fed

Source: Robert Shiller (Yale University), Bloomberg LP, and Center for Financial Stability.
Reserve Currencies: Shifting “Stores of Value”

Note: Composition of World Central Bank Reserves. “Other” is largely AUD, CAD, NOK, SEK and NZD. Source: Datastream, International Monetary Fund (COFER) and Center for Financial Stability.
About CFS and Disclosure

The Center for Financial Stability (CFS) is a private, nonprofit institution focusing on global finance and markets. Its research is nonpartisan.

The CFS is dedicated to the integration of finance, law, and economics. The organization is unique, as it focuses on market mechanics and linkages while serving as a private sector check on government actions.

This publication reflects the judgments and recommendations of the author(s). They do not necessarily represent the views of members of the Advisory Board or Trustees, whose involvement in no way should be interpreted as an endorsement of the report by either themselves or the organizations with which they are affiliated.


The Center for Financial Stability is a non-profit 501(c)(3) organization formed for educational purposes.