What I’ll Do

- Illustrate Roosevelt’s 1933 recovery efforts
  - differentiate between “unbacked” and “backed” fiscal expansion
  - departure from conventional Keynesian hydraulics
  - draws on “Recovery in 1933” with Maggie Jacobson & Bruce Preston

- Discuss how to extend fiscal theory reasoning to open economies
  - highlight features relevant to Japan

- Extract lessons for Japan
Recovery Narrative

- Roosevelt engineered an **unbacked fiscal expansion** to spur economic recovery

- In an unbacked fiscal expansion, government...
  1. increases spending—purchases or transfers
  2. issues nominal bonds to cover the deficit
  3. convinces people it will not raise taxes or cut spending in future to pay off the bonds

- New nominal debt is not expected to be “backed” by higher primary surpluses
  - agents see growth in nominal debt & no prospect of higher taxes/lower spending
  - higher inflation ⇒ nominal assets unattractive
  - shift out of assets into goods
  - raises aggregate demand: higher prices & output
  - Pigou-Keynes-Patinkin wealth effect
Recovery Narrative

1. Single-minded objectives
   ▶ “to restore commodity price levels. . .” & “get people back to work”
   ▶ once price level restored, maintain its constant value
   ▶ shift focus away from international to domestic concerns

2. Leaving gold standard a necessary condition
   ▶ Congress abrogated gold clauses in all public & private debt contracts—present & past
   ▶ converted effectively real debt into nominal debt

3. FDR kept citizens focused on recovery objectives
   ▶ committed to run “emergency deficits” until economy recovered
   ▶ making recovery the priority, shifted beliefs from orthodoxy that fiscal expansion begets consolidation
4. Fiscal choices state-dependent & temporary
   ▶ FDR: “the deficit of today makes possible the surplus of tomorrow”
   ▶ fiscal stimulus *not* a one-off policy

5. FDR framed argument for recovery in stark terms
   ▶ fighting a “war for the survival of democracy”
   ▶ choice between “...a rise in prices or a rise in dictators”
   ▶ by making stakes high, he could credibly suspend his deeply-held beliefs in sound finance *temporarily*

6. Nominal debt financed deficits (doubled in 7 years)
   ▶ pegged interest rate stabilized debt
   ▶ ensures interest payments don’t explode debt
   ▶ with reflation & recovery, government credit grew stronger, interest rates on borrowing declined
Recovery Was Stunning

- Remarkable timing of recovery: April 1933 the economy turned around
- Coincides with departure from gold
  - over course of 1933, Treasury & FDR steadily raised dollar price of gold from $20.67 to $30 an ounce
  - FDR was clear there would be no return to gold
- Jalil-Rua: inflation expectations rose sharply 1933Q2
Real Economic Activity

Output

Real GNP
IP

1920 1922 1924 1926 1928 1930 1932 1934 1936 1938 1940
60
70
80
90
100
110
120
130

1920 1922 1924 1926 1928 1930 1932 1934 1936 1938 1940
Real GNP
IP
Keynesian Hydraulics vs. UBFE

- Conventional thinking about fiscal stimulus
  - grounded in what Coddington calls “hydraulic Keynesianism”

- Textbook Keynesian: higher government spending . . .
  - raises real income/expenditures flows through multiplier mechanism
  - debt-financed deficits not part of the mechanism
  - reflected in most new Keynesian analyses

- To understand fiscal theory, need to contrast hydraulics with unbacked fiscal expansion
When Fiscal Expansion is Unbacked

- In addition to Keynesian hydraulics, nominal debt dynamics kick in.
- Debt dynamics amplify the impacts of fiscal expansion.

\[
\text{Unbacked Fiscal Multiplier} = \text{Keynesian Hydraulics Multiplier} + \text{Debt Dynamics Multiplier}
\]
Implications

1. BoJ has mostly pursued passive policy for decades
   ▶ just as the Fed in the 1930s
   ▶ less clear whether MoF has been living in an unbacked fiscal expansion regime

2. Much bigger fiscal effects from unbacked expansions
   ▶ eliminates negative wealth effect in Keynesian hydraulics
   ▶ instead, nominal debt dynamics raise wealth

3. No conflict between stimulus & sustainability
   ▶ debt stable whether expansions are backed or unbacked (as I’m defining unbacked)

4. Need to anchor expectations appropriately
   ▶ FDR convinced people expansions would be unbacked until recovery
Theoretical Extensions Important for Japan

1. Integrate price-level & exchange-rate determination
   ▶ natural extension of intertemporal approach to CA
   ▶ delivers equilibrium conditions for open economies

2. Special to Japan
   ▶ financial sector heavily invested in government bonds (43%)
   ▶ government owns sizeable international reserves (23% of GDP since 2000)
   ▶ private sector holdings of foreign assets small relative to government’s
   ▶ central bank holds substantial government debt (38%)
   ▶ chronic trade surpluses
   ▶ little foreign ownership of government bonds (10%)

3. When government owns foreign assets, price level reflects present values of primary budget surpluses and trade balances
Sizeable Official Reserves

Japanese Official Reserves
Percentage of GDP
Growing BoJ Ownership of Bonds

Japanese Central Government Debt
Percentage of GDP

Total (internal)
Held by BoJ
Held by Others
Persistent Trade Surpluses

Japanese Trade Balance
Percentage of GDP
Contrasts Between FDR & Japan

1. Japanese policies have lacked single-mindedness
   ▶ BoJ raised rates in early 90s; again in 2006–08
   ▶ governments have flip-flopped on fiscal policy
     ▶ stimulus followed by consolidation
     ▶ caved to IMF pressure to raise consumption tax
   ▶ not engaging in unbacked fiscal expansion

2. Japanese policies not state-contingent
   ▶ government spending typically one-off
   ▶ consumption tax hikes permanent

3. Objectives have been confused
   ▶ one day it’s recovery; next day it’s debt reduction

4. Policymakers perceive the hydraulics trade-off
   ▶ tension between fiscal stimulus & sustainability
   ▶ no such trade-off for unbacked expansions