Fiscal Policy & Colored Animals

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The Message

If we allow the
The Message

to distract us from the
The Message

we make more likely the
### The Stimulus Package

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>−2019</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Budget Authorization</strong></td>
<td>379.0</td>
<td>114.7</td>
<td>53.6</td>
<td>11.2</td>
<td>9.8</td>
<td>16.2</td>
<td>580.9</td>
</tr>
<tr>
<td><strong>Outlay Rises</strong></td>
<td>120.1</td>
<td>219.3</td>
<td>126.2</td>
<td>46.2</td>
<td>30.3</td>
<td>27.9</td>
<td>575.5</td>
</tr>
<tr>
<td><strong>Revenue Cuts</strong></td>
<td>64.8</td>
<td>180.1</td>
<td>8.2</td>
<td>−9.9</td>
<td>−2.6</td>
<td>−5.4</td>
<td>213.0</td>
</tr>
<tr>
<td><strong>Net Increase in Deficit</strong></td>
<td>184.9</td>
<td>399.4</td>
<td>134.5</td>
<td>36.2</td>
<td>27.7</td>
<td>22.5</td>
<td>788.5</td>
</tr>
</tbody>
</table>

*Billions of Dollars. Source: Congressional Budget Office*

A mix of tax cuts, infrastructure spending, direct purchases & transfer payments
Interest rates, however, have fallen to historically low levels, so despite the higher levels of debt, interest costs have not yet increased significantly. Interest rates are expected to rise noticeably in the next few years, though, and under the assumptions of CBO’s baseline, debt held by the public is projected to exceed 69 percent of GDP by the end of 2020. As a result, over the next decade, the government’s annual net spending for interest is projected to more than double as a share of GDP, increasing from 1.5 percent in 2011 to 3.4 percent by 2020 (see Summary Figure 2). Over the 10-year projection period, such spending grows at an average rate of 15 percent a year.

The Economic Outlook

The pace of growth after the recent recession is likely to be slower than usual as the economy recovers from the effects of the financial crisis and as the support to economic activity provided by fiscal policy diminishes. In the past, many recoveries from deep recessions have been quite robust. After deferring purchases during a slump (especially for expensive goods like homes, automobiles, and capital equipment), households and businesses typically boost their spending quickly as economic prospects improve. However, international experience suggests that recoveries from recessions that were spurred by financial crises tend to be slower than average—perhaps because the losses in wealth and damage to the financial system that occur during such crises weigh on spending for a number of years. Following such a crisis, it takes time for consumers to rebuild their wealth, for financial institutions to restore their capital bases, and for nonfinancial firms to regain the confidence required to invest in new plant and equipment; all of those forces tend to restrain spending. In addition, under current law, both the waning of fiscal stimulus and the scheduled increases in taxes will temporarily subtract from growth, especially in 2011. In CBO’s projections, real GDP increases by 2.8 percent between the fourth quarter of calendar year 2009 and the fourth quarter of 2010 and by 2.0 percent in 2011 (see Summary Table 2). Such rates of growth are well below 1970-1975-1980-1985-1990-1995-2000-2005-2010-2015-2020

Source: Congressional Budget Office.
The Total Budget Deficit or Surplus
(Percentage of gross domestic product)

Source: Congressional Budget Office.
Deficit Fears

- Within a week of passage of stimulus, Obama pledged to reduce deficit by 50% within four years

- Congress reluctant to extend Bush tax cuts

- Many European countries, after big fiscal stimuli in 2009, are now cutting spending & raising taxes

- Fiscal austerity *even in the face of a weak economic recovery*

- Decisions driven by fear and speculation about fiscal crises
An economic theorem

United States $\neq$ Greece

- There is always a tradeoff between short-run stimulus and long-run sustainability
- Fiscal institutions do not guarantee policies that are sustainable in long run
- Policymakers aim to prove their long-term bona fides through short-term austerity
- Whether austerity is good policy is not part of the calculus
Why is this a fish?

- Applying the theorem United States $\neq$ Greece
- Greece had reached its “fiscal limit”
  - politically costly to raise revenues or cut spending
  - could no longer borrow without paying huge premium
- U.S. very far from its *economic* limit
- U.S. has history of honoring its debt by adjusting taxes & spending
- Can just retire debt back to pre-recession levels (as always)
- Fears of an impending U.S. fiscal crisis are unfounded and distracting from the real issues
Like many advanced economies, U.S. headed into prolonged *era of fiscal stress*

<table>
<thead>
<tr>
<th>Country</th>
<th>Aging-Related Spending</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>726</td>
</tr>
<tr>
<td>France</td>
<td>276</td>
</tr>
<tr>
<td>Germany</td>
<td>280</td>
</tr>
<tr>
<td>Italy</td>
<td>169</td>
</tr>
<tr>
<td>Japan</td>
<td>158</td>
</tr>
<tr>
<td>Korea</td>
<td>683</td>
</tr>
<tr>
<td>Spain</td>
<td>652</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>335</td>
</tr>
<tr>
<td>United States</td>
<td>495</td>
</tr>
<tr>
<td>Advanced G-20 Countries</td>
<td>409</td>
</tr>
</tbody>
</table>

Worldwide “Unfunded Liabilities.” Net present value of impact on fiscal deficit of aging-related spending, in percent of GDP. Source: IMF
Some facts about long-run U.S. fiscal position

1. Budget imbalance in Social Security, Medicare, Medicaid: $75 trillion

2. Shortfall in state pensions: $3.3 trillion

3. Cost of making Bush tax cuts permanent: $4 trillion

4. Potential loses from Freddie Mac and Fannie Mae: $1 trillion

Pretty soon you’re talking real money

But the problem is not today’s deficit—it’s all future deficits

Congressional Budget Office accounting tells much of the story
Monetary policy (the Fed) & fiscal policy (the President and Congress) have two macroeconomic tasks to perform:

1. control inflation
2. maintain value of government debt

Normally, we assign the Fed to control inflation & fiscal policy to stabilize debt

But things are symmetric: fiscal policy can control inflation & the Fed can maintain value of debt

Precedents: World War II and last several years

- by keeping interest rates low, Fed makes real debt service stable

Bottom line: if fiscal policy not stabilizing debt, it can exert a powerful influence on inflation rates
Some More Economic Theory

- To ensure the usual assignment of tasks...
  - with monetary policy controlling inflation, ...
  - need to anchor expectations of fiscal policy in right way
- Anchor beliefs on policies that imply
  - whenever government debt rises, people believe taxes will rise or spending will fall in the future
  - this maintains the value of debt
  - called “sustainable” fiscal policies
- Current policies are not sustainable
- With no plans in place to adopt sustainable policies...
- What will anchor beliefs about fiscal policies in an era of fiscal stress?
Now we get to the

- Draws on recent research on resolving fiscal stress (done in IU economics department)
- Era of fiscal stress unprecedented in U.S.
  - problem with unprecedented things is they don’t happen much
  - past policy may be a poor guide to future
- U.S. treasuries still highly valued
  - people must expect future policies to adjust to back the debt
- Policy institutions provide no information about those future adjustments
How Pink Elephants Beget Black Swans

- Feed CBO’s projection of “promised” old-age benefits into an economic model
- Posit alternative policy adjustments & probabilities of them
  1. some rise in taxes
  2. some entitlements reform
  3. some increase in inflation
- Simulate model, reflecting uncertainty about future policies
- Compute model’s predictions of GDP, employment, inflation, etc
- Here I focus on a single message:
  Unresolved fiscal stress can undermine the Fed’s ability to control inflation and influence economic activity
How Pink Elephants Beget Black Swans

- Each adjustment (1)–(3) contributes to stabilizing debt
- In this sense, we posit “orderly resolutions”
- If promised benefits were not growing relentlessly
  - actual & expected inflation would be anchored on the Fed’s target of 2% inflation
  - fiscal policy adjustments alone would stabilize debt
  - fiscal expectations would be anchored on sustainable policies
- With growing promised entitlements, the Fed can no longer control inflation
In the absence of fiscal stress, expected inflation anchored on 2%.

Source: Davig, Leeper & Walker (2010)
Averages mask the extreme possibilities

Inflation has a “fat tail” meaning that extremes are more likely than they normally are

Need to examine upper tail of inflation

Compute the average of the 0.5% upper inflation rates
In the absence of fiscal stress, actual inflation anchored on 2%

Average of 0.5% upper tail of inflation

Source: Davig, Leeper & Walker (2010)
What if Resolution is Disorderly?

- It’s quite likely that economy may go through a period when *no one* is stabilizing debt
- Could happen if the Fed reacts to rising inflation but sharply increasing the interest rate
- This raises real interest rates & real debt service
- Debt grows rapidly
- If expectations still not anchored on sustainable fiscal policies...
- Much worse inflation outcomes become probable
Inflation in an era of fiscal stress

- Inflation when taxes rise to stabilize debt
- Inflation when no policies stabilize debt

Source: Davig & Leeper (2010)
What To Do?

- Even in normal times, uncertainty about fiscal policy causes people to hedge, retards growth and produces bad decisions.
- In an era of fiscal stress, fiscal uncertainty is amplified and potentially more deleterious.
  - Can undermine Fed’s efficacy.
- It’s not too late for policymakers to make meaningful reforms.
- A fiscal crisis is not inevitable.
- Need some reforms to get there:
  1. Independent scrutiny—*not decision making*—of fiscal policy.
  2. Serious analysis of alternative policies & their effects.
  3. Find aspects of fiscal policy that are less political and more susceptible to analytics.