Economics 1: Fall 2010

J. Bradford DeLong, Michael Urbancic, and a cast of thousands...

http://delong.typepad.com/econ_1_fall_2010/
Ladies and Gentlemen, to Your i>Clickers...

• At the moment, three of the seven seats on the Federal Reserve Board are vacant, and the chair of the Federal Reserve expresses the consensus. That means that the voting members of the FOMC excluding the chair now consist of:
  – A. Four chosen by bankers, two Democratic appointees, and two Republican appointees
  – B. Five chosen by bankers, one Democratic appointee, and two Republican appointees
  – C. Five chosen by bankers and four Democratic appointees
  – D. Seven Republican appointees and one Democratic appointee
  – E. Eight Democratic appointees
Economics 1: Fall 2010: The Long-Run Government Budget

J. Bradford DeLong

September 20, 2010, 12-1
Wheeler Auditorium, U.C. Berkeley
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The National Debt

Federal Debt Truly Held by the Public/GDP
Federal Spending and Revenue: History and Near Future

Summary Figure 1.
Total Revenues and Outlays
(Percentage of gross domestic product)

Source: Congressional Budget Office.
Ladies and Gentlemen, to Your i>Clickers...

• Historically, before 1980, the U.S. debt-to-GDP ratio rose:
  – A. Only in wars
  – B. Only in great depressions
  – C. Only in wars and great depressions
  – D. Even in prosperous peacetime
Federal Spending and Revenue: Longer-Term Outlook

Alternative Fiscal Scenario

Source: Congressional Budget Office.

Notes: Primary spending refers to all spending other than interest payments on federal debt.

The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections through 2020 (with adjustments for the recently enacted health care legislation) and then extending the baseline concept for the rest of the long-term projection period. The alternative fiscal scenario incorporates several changes to current law that are widely expected to occur or that would modify some provisions that might be difficult to sustain for a long period. (For details, see Table 1-1 on page 3.)

CHIP = Children's Health Insurance Program.
The “Current-Law Baseline” Is Close to Balanced

• Primary fiscal gap of 1.2% of GDP over the next 25 years
• But the CBO does not believe congress and the president will stick to the current-law baseline
  – “Middle class” tax cuts (0.7%)
  – High bracket tax cuts, estate tax, etc. (0.6%)
  – “AMT fix” (0.3%)
  – “doc fix” (0.2%)
  – R&D credit (0.1%)
  – Special tax on high-cost health plans (0.8%)
  – iPAB (0.9%)

• Alternative fiscal scenario: primary fiscal gap of 4.8% of GDP
What Happens If a Government Loses the Confidence of Its Creditors?

- Zimbabwe
- Four lesser examples:
  - Mexico 1995
  - East Asia 1997-1998
  - Argentina 2001-2002
  - Greece 2010
- Are we close to the edge now?
  - No
- Will we be someday?
  - Perhaps
- When?
  - We don’t know...
Ladies and Gentlemen, to Your i>Clickers...

• Why did the U.S. debt-to-GDP ratio rise from 1981-1993 and from 2001-2007?
  – A. Because of big wars
  – B. Because of great depressions
  – C. Because of wars and great depressions
  – D. Because the Republican Party decided to play Santa Claus
  – E. Because the Democratic Party forced the Republican Party to unbalance the budget
The Debt Equation

• \((D/Y)_t = d^p_t + (1 + r - g)(D/Y)_{t-1}\)

• The debt-to-GDP ratio this year is equal to the primary deficit + the debt-to-GDP ratio last year times the sum of one plus the real interest rate on government debt minus the growth rate of the economy

• Solve for the stable debt-to-GDP ratio:
  – Stability: \((D/Y) = -\frac{d^p_t}{(r - g)}\)
    • If \(r > g\), there had better be a primary surplus...
    • If \(r < g\), what is the problem?
    • But will \(r < g\)?
      – If people lose confidence in your government—if \(r\) goes up—then you can get into big trouble immediately
What Does Big Trouble Look Like?
Ladies and Gentlemen, to Your i>Clickers...

• What is the most likely outcome for the U.S. budget come 2060?
  – A. We will have raised taxes to pay for government health spending.
  – B. We will have cut doctors wages and enslaved them by drafting them into a socialist national health service.
  – C. We will have abandoned our commitment to providing state-of-the-art health care to the sick and not just the wealthy.
  – D. The health care fairy will have figured out a way for us all to have all the medically-appropriate care we need for a surprisingly low private and public budgetary cost.
  – E. The federal government as we know it will have collapsed, and those of us still alive will be starring involuntarily in a remake of “Mad Max: Beyond Thunderdome”
Economics 1: Fall 2010: The Government Budget in the Medium Run

J. Bradford DeLong

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Suppose That We Are Not in a “Depression Economics” Situation...

- $Y = Y^*$
- $Y = C + I + G + NX$
- $C = c_0 + c_y Y$
- $Y^* = c_0 + c_y Y^* + I + G + NX$
- $(I + G + NX + c_0) = Y^*/(1-c_y)$
  - If $G$ goes up—and if nothing happens to $c_0$—then $I$ and $NX$ will go down
  - Do we like having $I$ and $NX$ go down? Probably not...
How Do NX and I Fall?

• **NX:**
  – Government issues more bonds
  – Bond prices fall in dollars
  – Interest rates rise
  – More foreigners who have sold us imports decide not to buy exports but instead to take advantage of the higher interest rates and buy bonds
  – NX falls

• **I:**
  – Government issues more bonds
  – Bond prices fall
  – Interest rates rise
  – Businesses that were planning to borrow more and invest and expand their capacity decide not to do so
  – I falls

• Unless we really want to shrink I or NX...
  – Expansions of G should be accompanied by steps to diminish $c_0$
  – What are those measures?
  – Generally tax increases...
Nobody Likes Tax Increases...

- But we have to do them eventually
  - Or else debt crises and hyperinflation...
- What if we postpone them?
  - A good reason to postpone them: depression economics—a cyclical deficit is a good thing
  - But if we are not in depression economics, postponing deficits lowers NX and lowers I
- Hence two rules
  - Balance over the business cycle
  - Milton Friedman’s PAYGO
Are These Rules Sustainable?

• James Buchanan’s critique:
  – “cyclical deficit in downturns good, permanent structural deficit bad” is just too complicated for the political system to process
  – Hence tolerate and approve of cyclical deficits to fight downturns
  – And you are setting the political stage for permanent structural deficits
  – That will slow growth
  – And possibly lead to financial crises and hyperinflation
Is Buchanan Right?

• The possibility seems distressingly likely
• The number of excuses to avoid tax increases is infinite...
• The number of ways since 1980 that people—usually Republicans—have found to try to permanently unbalance the government budget in the long run is truly astonishing...
  – The “Laffer Curve”: cut taxes and actually raise tax revenues:
    • Works in some “depression economics” situations
    • Works with tariffs
    • Works when the taxes are just the levers for corrupt extortion
    • In the North Atlantic? Not so much...
      – A Laffer coefficient of 1/10 is what you should keep in the back of your mind
Never Trust the Wall Street Journal

WSJ Forecasts
06: no housing bubble
07: subprime crisis will not spread
08: we aren’t in recession
09: high inflation is coming
10: high interest rates are coming
Test Your Knowledge

• When in American history has the debt-to-GDP ratio risen?
• What happens when a government’s creditors—the bondholders—conclude that a government might never close its fiscal gap?
• What is the CBO’s budget baseline—the thing that shows only a small fiscal gap (1.2% of GDP) over the next 25 years?
• So our budgetary situation right now is fine—except that we want to run short-term deficits in order to reduce cyclical unemployment—right?
We Don’t Need Another Hero...