Economics 1: Fall 2010

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

http://delong.typepad.com/econ_1_fall_2010/
We Don’t Need Another Hero...
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

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September 20, 2010, 12-1
Wheeler Auditorium, U.C. Berkeley
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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: \((D/Y) = -d^p_t / (r - g)\)
    • 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
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 by 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
Ladies and Gentlemen, to Your i>Clickers...

• Why is it important for a government to run a long-run primary surplus?
  – A. Because a failure to do so will crowd out productive investment.
  – B. Because a failure to do so will slow economic growth.
  – C. Because a failure to do so will cause an immediate hyperinflation.
  – D. Because if it does it must then force the rate of interest on government debt below the growth rate of the economy.
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
Ladies and Gentlemen, to Your i>Clickers...

James Buchanan argues that even cyclical deficits should be avoided, because “cyclical deficits good, structural deficits bad” is too difficult for American politics to understand. But is he right? After all, the animals in George Orwell’s “Animal Farm” had no trouble understanding the slogan: “four legs good, two legs bad.”

A. He is right, because American members of congress and journalists are dumber than pigs and chickens.

B. He is wrong, because American members of congress and journalists are smarter than pigs and chickens.

C. He is wrong, because even though American members of congress and journalists are dumber than pigs and chickens, then can be educated to believe that cyclical deficits are not really deficits, in the same way that Squealer convinced the birds of animal farm that a wing is an organ of locomotion and hence properly classified not as an arm but as a leg.

D. He is right because even though politicians know that structural deficits are destructive and cyclical deficits helpful, they will pretend otherwise whenever it is in their short-term political interest to do so.
Test Your Knowledge

• Since the interest rate on Treasury debt is less than the economy’s growth rate, our budgetary situation right now is fine, except that we want to run short-term deficits in order to reduce cyclical unemployment—right?
• How do you calculate that long-run debt-to-GDP ratio?
• Why is it important that a government run a primary surplus?
• Even if the national debt is sustainable, why is it good to run a balanced budget—or even a surplus—over the business cycle?
• Why don’t governments run balanced budgets over the business cycle?
• What is James Buchanan’s critique of even cyclical deficit spending?
• What is the Laffer curve?
• Should you ever trust the Wall Street Journal?