Fiscal Policy in a Depressed Economy: Further Thoughts

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Six Years Ago

- Near consensus fiscal policy had next to no role.
- Dominance of John Taylor’s argumetn that aggregate demand management was the exclusive province of central banks.
- Problems with fiscal policy: legislative confusion, legislative process, implementation, rent-seeking.
- Most important: monetary policy can and will do the job.

Bankers Say They Can't Do the Job

- Although monetary policy is working... it cannot carry the entire burden…. Congress and the Administration [should] put the federal budget on a sustainable long-run path... without unnecessarily impeding the current recovery…. [L]owering the deficit has been concentrated in [the] near-term… which… could create a significant headwind for the economic recovery… slow the pace of real GDP growth by about 1-1/2 percentage points this year…
- [T]the Congress and the Administration should consider replacing the sharp, frontloaded spending cuts required by the sequestration with policies that reduce the federal deficit more gradually…. Such an approach could lessen the near-term fiscal headwinds facing the recovery…

Flashback to DeLong and Summers (2012)

Present-period higher output via multiplier

Future-period higher output via reduced shadow

Output cost from raising taxes to amortize debt

$$\Delta V = [\mu(1 + \eta(1 + \xi\tau)/(r-g)) - \xi(1 - \mu\tau)]\Delta G$$

Counterfactual difference in present value of output

Counterfactual temporary expansion of government purchases

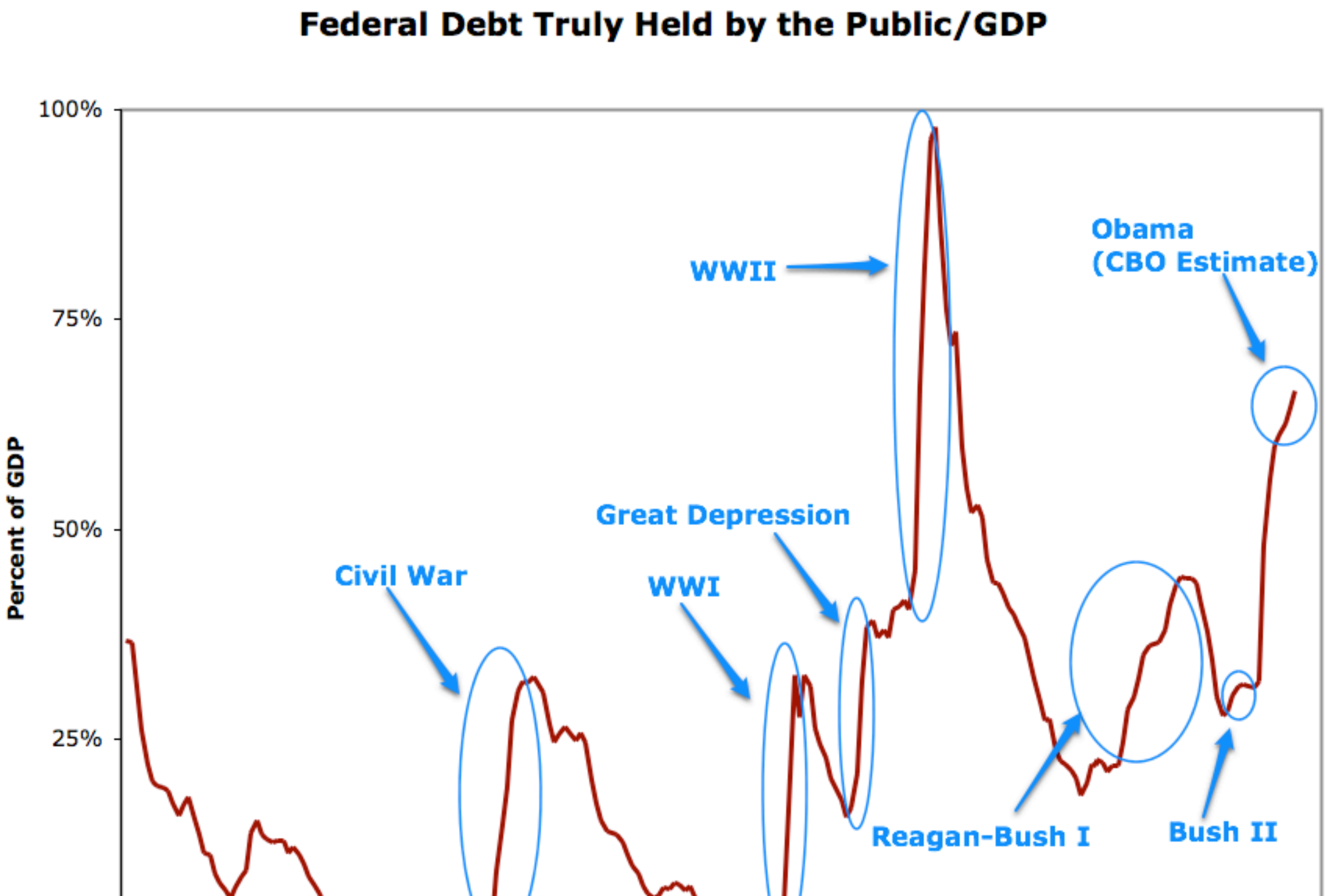
In Words...

- The net benefits (if any) of pulling a dollar of spending forward in time from the future into the present (or pushing back taxes) depend on three things:
    - How expensive in the future will it be to have run up the debt now?
    - How much the long-run health of the economy depends on short-run health
    - Whether and to what extent a spending boost now would actually boost production and employment

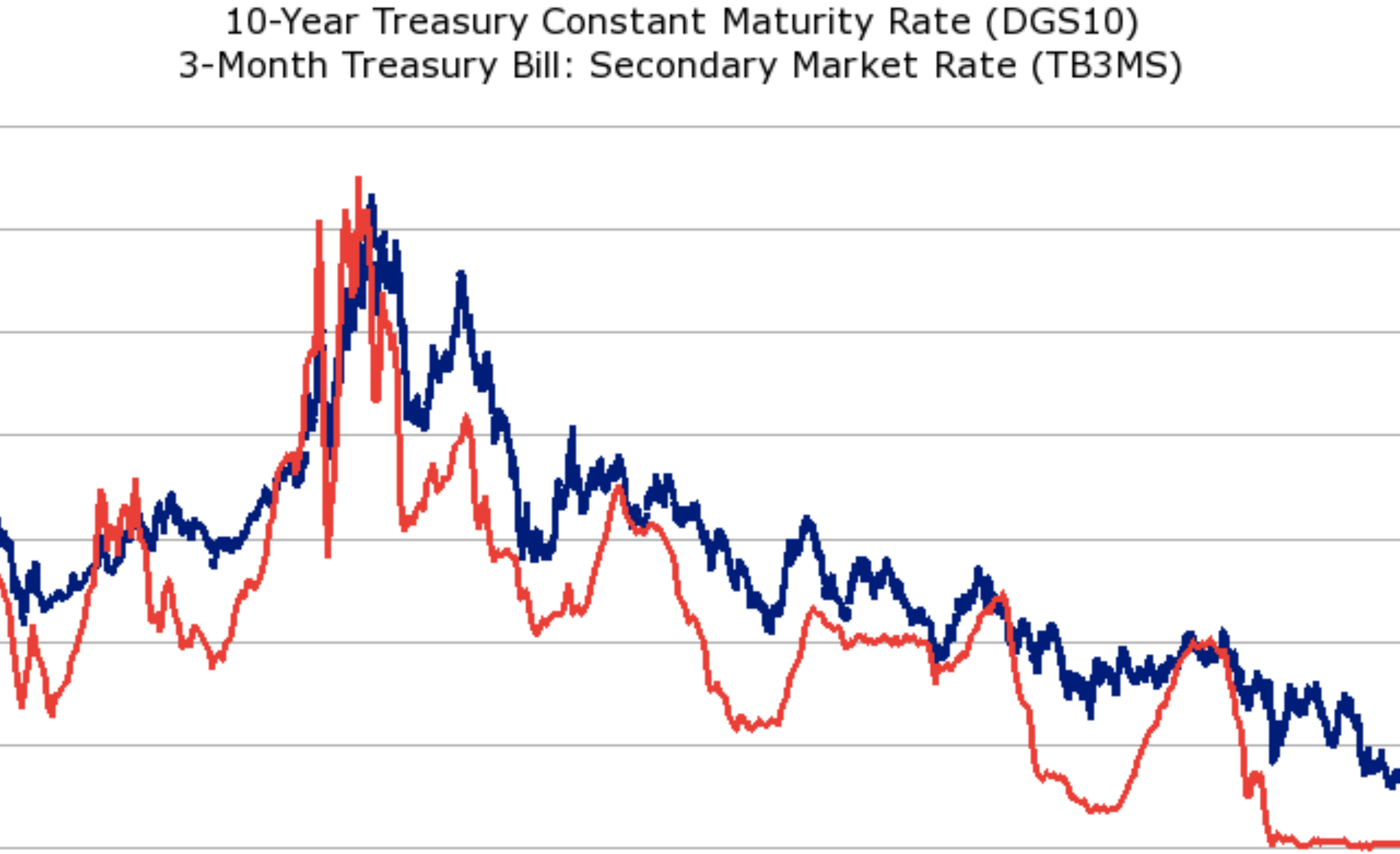
How Expensive Will It Be to Have Boosted the Debt?

- How much will the interest burden of financing the debt be?
- How much of a drag will having a high debt-to-annual-GDP ratio be?

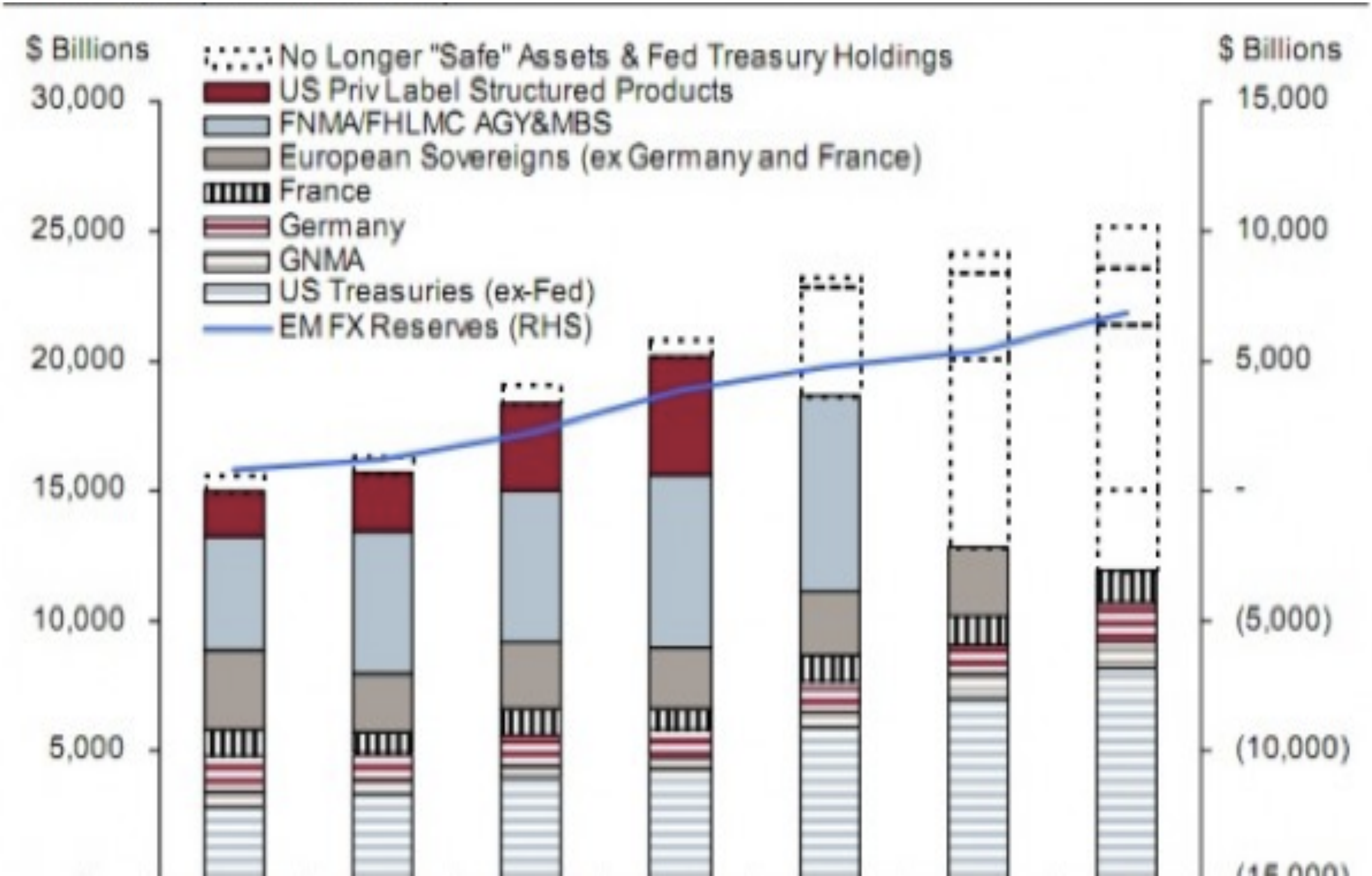
The Debt Path Looks Scary



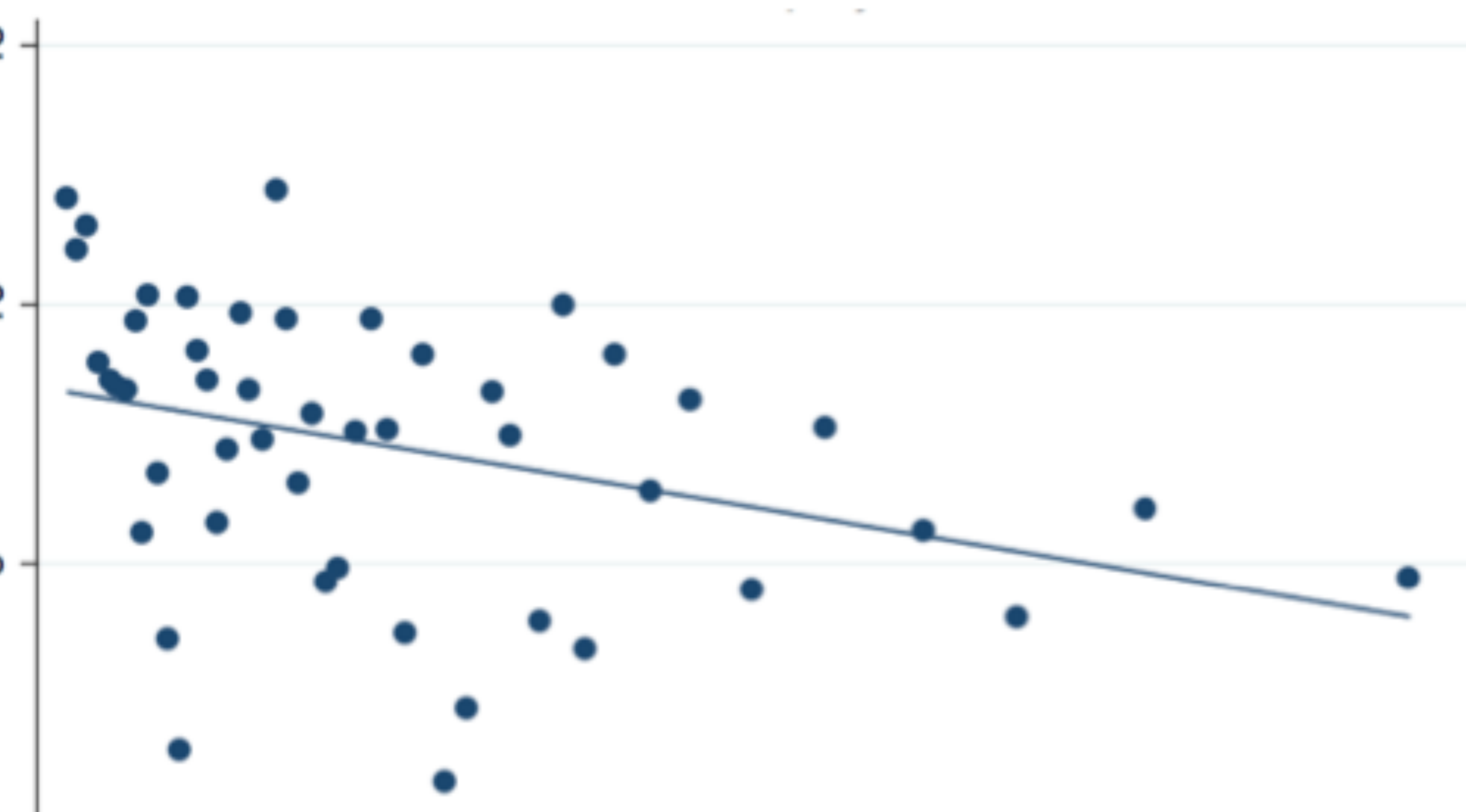
But Interest Rates Are and Are Expected to Remain Low



Shortage of Assets Seen as Safe



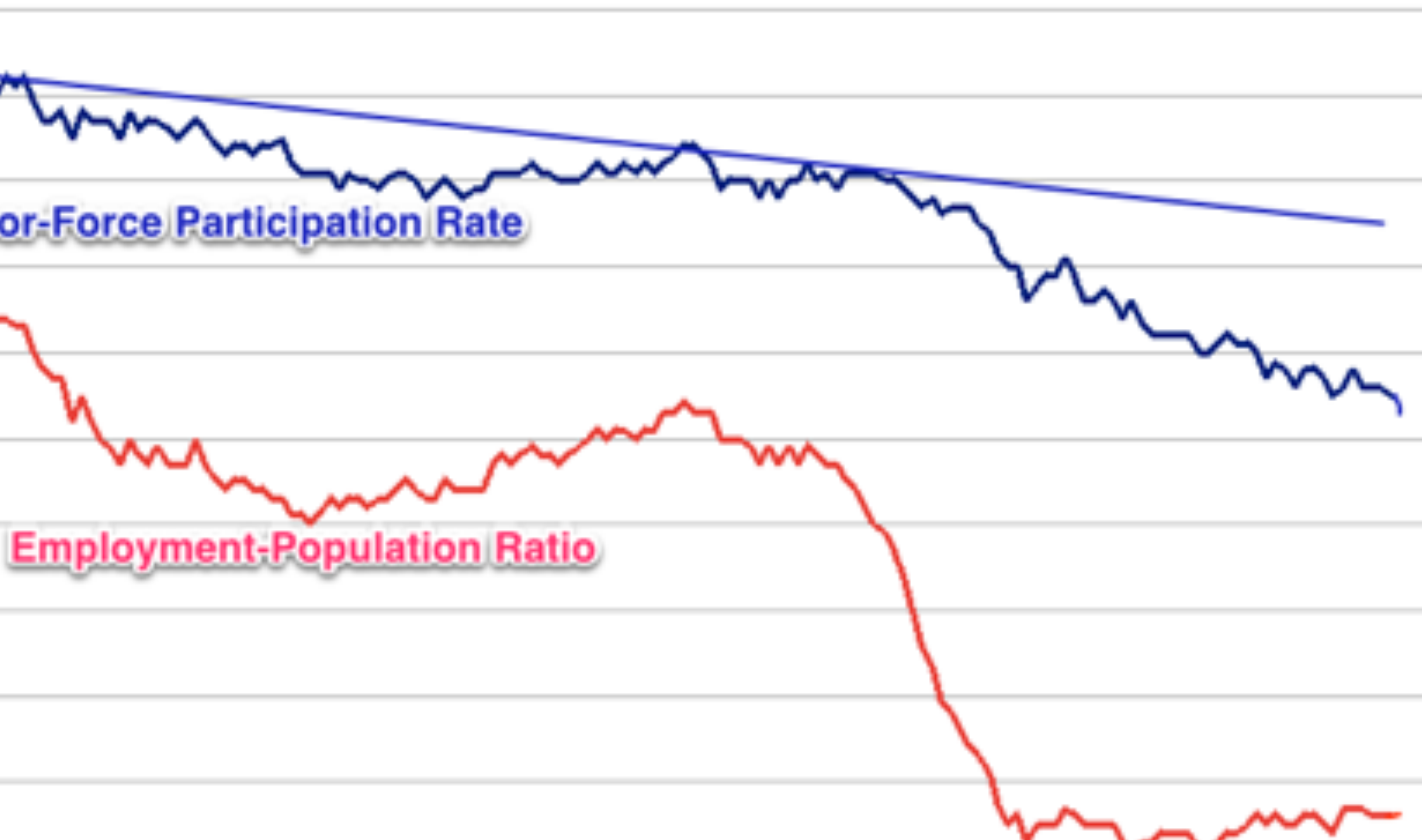
The Drag of High Debt on Economic Growth



But the Quantitative Size of the Effect Is Small

- Starts out at 0.06% point/year growth reduction from moving debt from 75% to 85% of annual GDP
  - With a multiplier of 2 and a 10-year impact we're comparing 20% to 0.6%
- Incorporate era and country effects: down to 0.3% points/year
- Debt-to-annual-GDP has a numerator and a denominator--to some degree high debt-to-annual-GDP is a sign that something is going wrong with growth
- And would expect high interest rates to discourage growth
- How much is left hen we consider (a) countries with low interest rates where (b) high debt-to-annual GDP is not driven

Economy Depend on a Good Short Run?



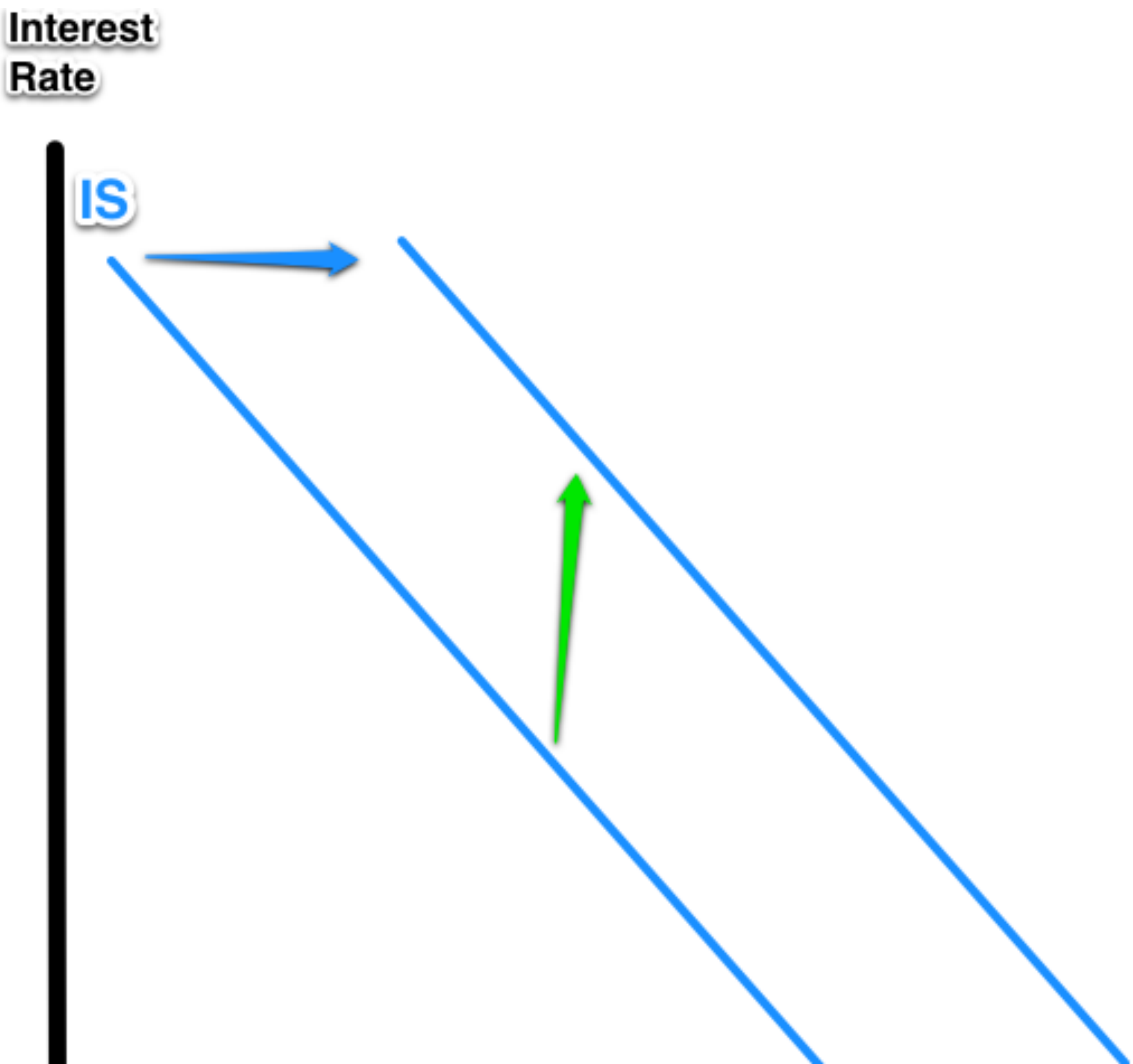
Self-Financing Fiscal Expansion

- In which case we aren't comparing costs and benefits, but benefits and benefits...
- τ: tax rate. η: shadow cast on the long run by a bad short run. μ: Keynesian multiplier. g: long-run growth rate. i: nominal Treasury borrowing rate. π: inflation rate
- Expansionary fiscal policy is self-financing when:
  - $(i-\pi-g)(1-\mu\tau) < \mu\eta\tau$
  - $(i-\pi-g)(1-\mu\tau) < .045 + 2\eta$
  - τ: 33%. μ: 2. g: 2.5%. η: ?. r: currently 1.5%. π: 2%.
  - $i < 4.5\% + 2\eta$

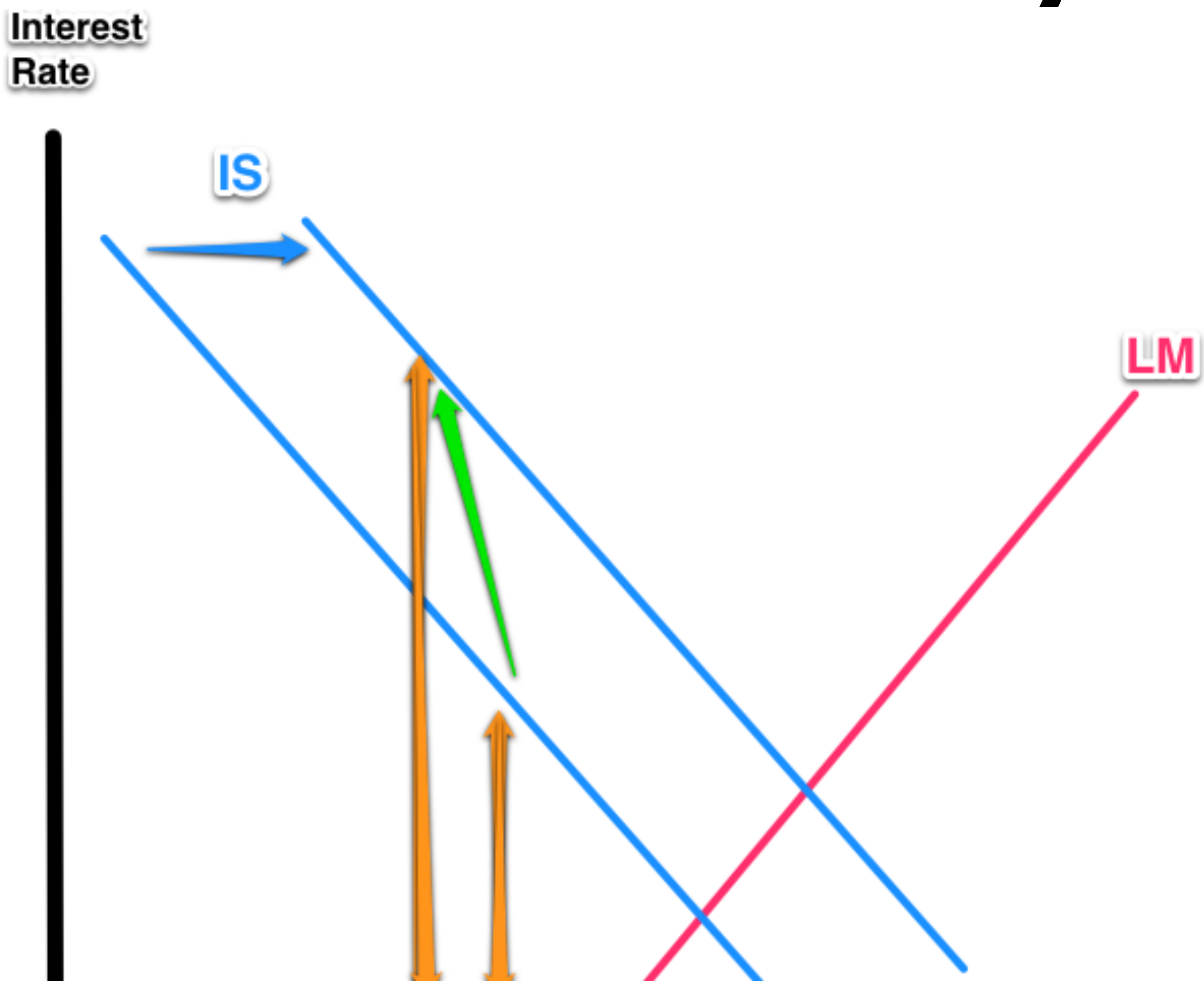
Work to Boost Production and Employment in the Short Run?

- The argument that interest rates on Treasuries would rise sharply—1992-1993 in reverse
- The argument that interest rate spreads would rise
- The argument that uncertainty would rise and tank the stock market
- The argument that multipliers are too small to matter
- The argument that it can't work in theory,
- The argument that the economy "needs" this.

Rates Would Rise: Crowding Out!



Would Rise, Scaring the Confidence Fairy

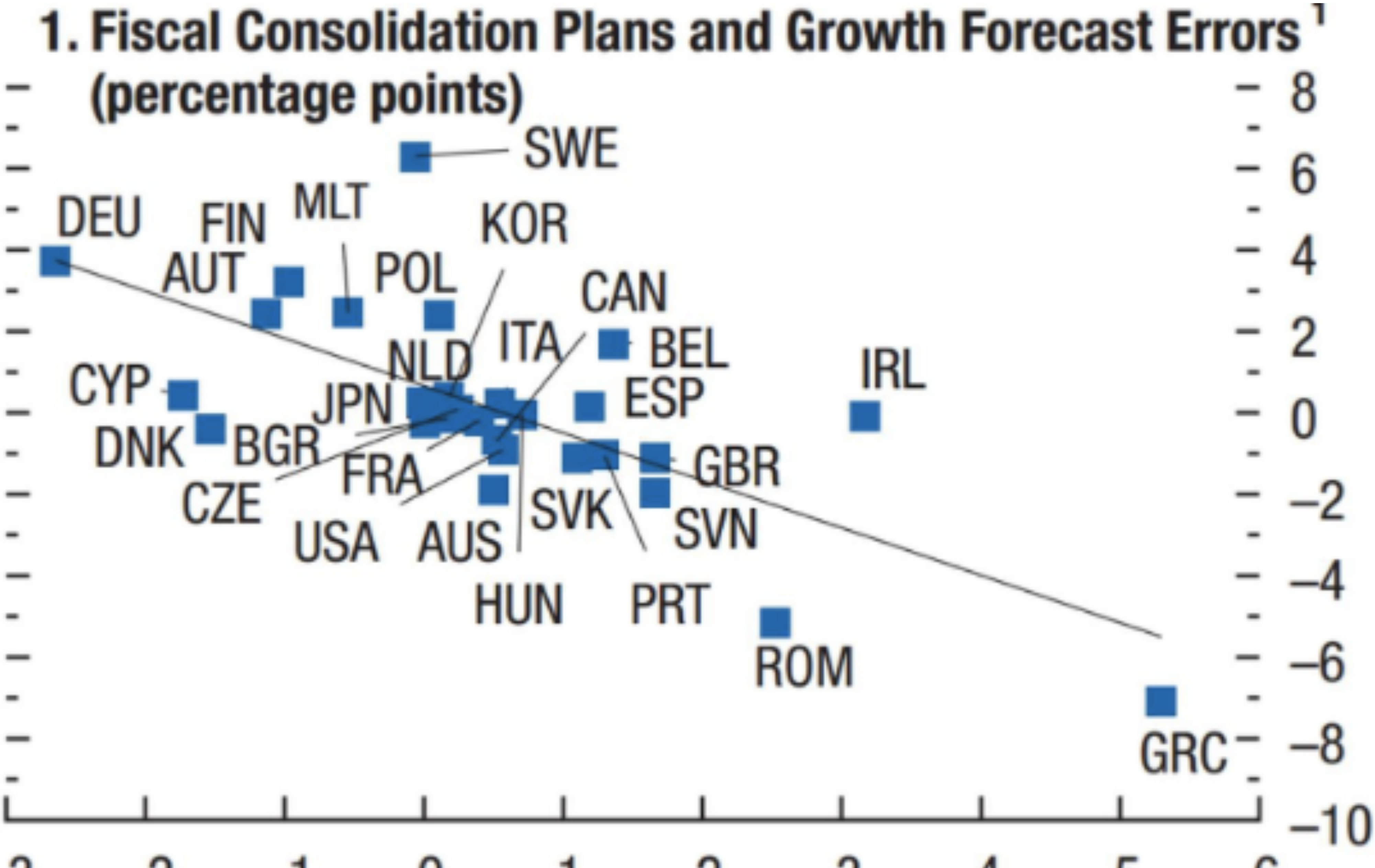


The Argument That "Uncertainty" (without Rising Interest Rates) Depresses the Economy

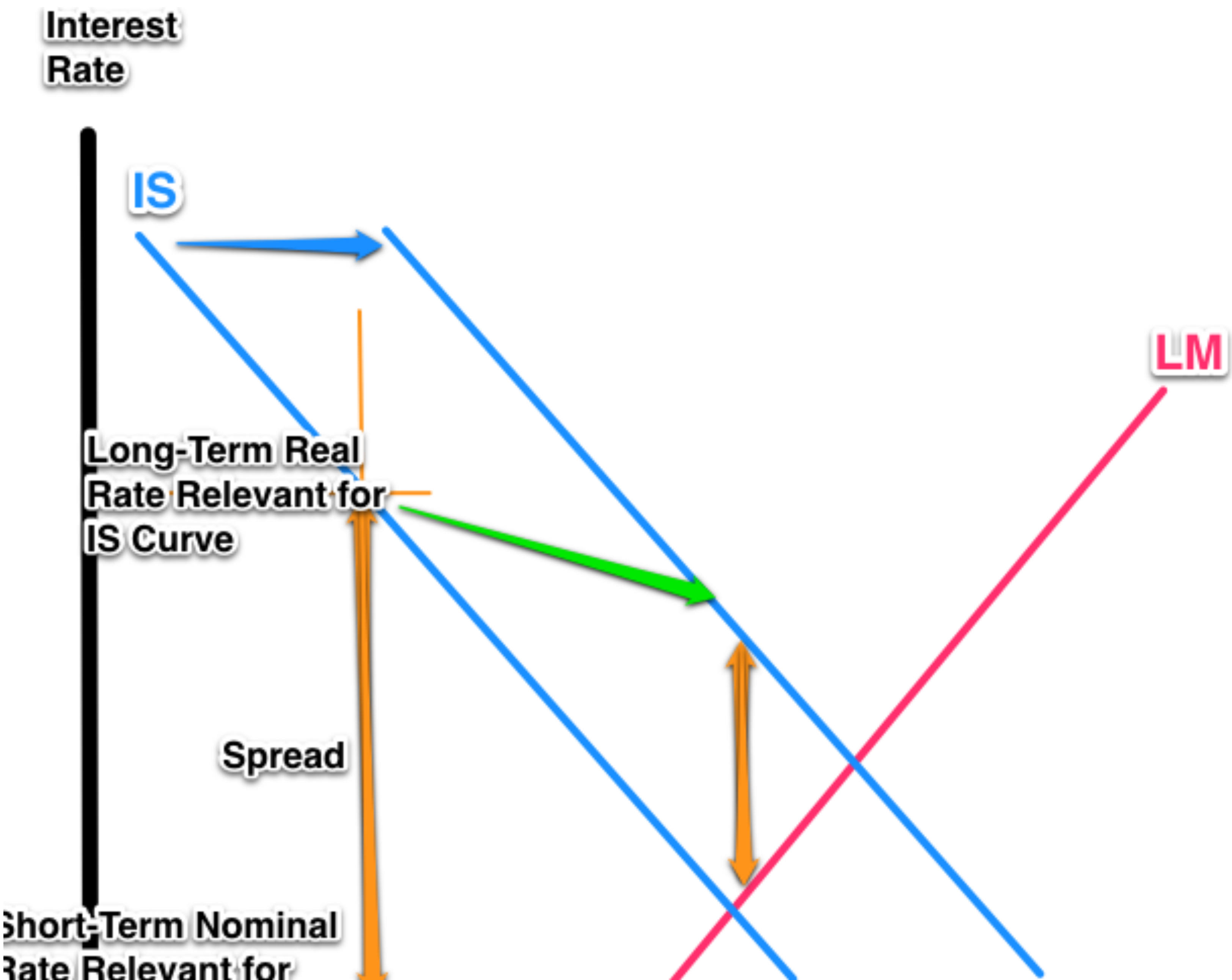
Policy uncertainty and job growth correlation

The Argument That "Uncertainty" (without Rising Interest Rates) Depresses the Economy

Multipliers Are too Small—Never Mind Why



Multipliers at the Zero Nominal Lower Bound



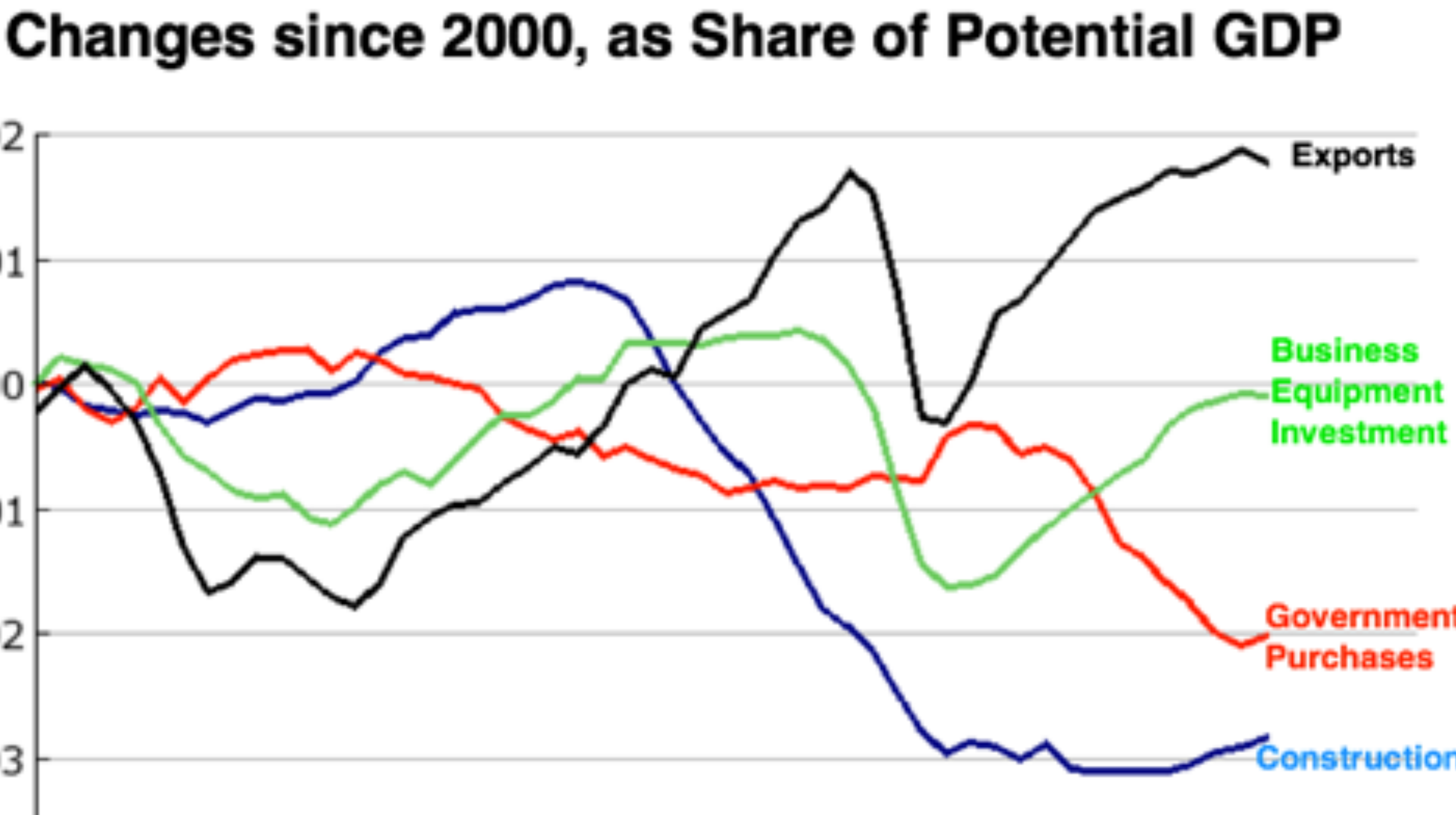
The Argument That It Can't Work in Theory

- Robert Lucas:
  - Christina Romer--here's what I think happened. It's her first day on the job and somebody says, you've got to come up with a solution to this--in defense of this fiscal stimulus, which no one told her what it was going to be, and have it by Monday morning.... [I]t's a very naked rationalization for policies that were already, you know, decided on for other reasons…. If we do build the bridge by taking tax money away from somebody else, and using that to pay the bridge builder--the guys who work on the bridge -- then it's just a wash... there's nothing to apply a multiplier to. (Laughs.) You apply a multiplier to the bridge builders, then you've got to apply the same multiplier with a minus sign to the people you taxed to build the bridge. And then taxing them later isn't going to help, we know that...
- John Cochrane:
  - If the government borrows a dollar from you, that is a dollar that you do not spend, or that you do not lend to a company to spend on new investment. Every dollar of increased government spending must correspond to one less dollar of private spending. Jobs created by stimulus spending are offset by jobs lost from the decline in private spending. We ca

Economy "Needs" This

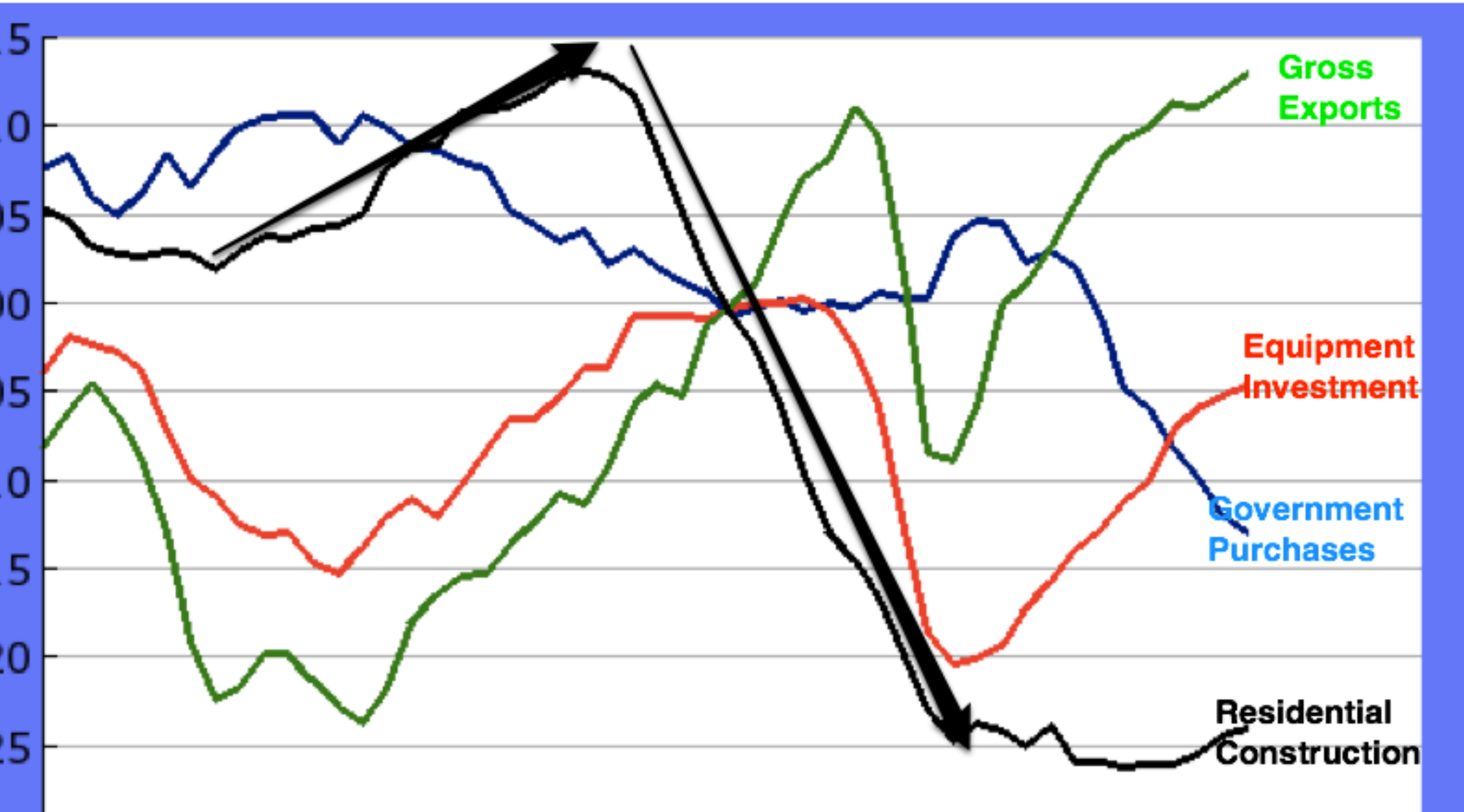
- Andrew Mellon (according to Herbert Hoover):
  - The "leave it alone liquidationists" headed by [my] Secretary of the Treasur Mellon, who felt that government must keep its hands off and let the slump liquidate itself. Mr. Mellon had only one formula: "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate." He insisted that, when the people get an inflation brainstorm, the only way to get it out of their blood is to let it collapse. He held that even a panic was not altogether a bad thing. He said: "It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people"...
- Joseph Schumpeter:
  - Recovery is sound only if it does come of itself. For any revival which is merely due to artificial stimulus leaves part of the work fo depressions undone and adds, to an undigested remnant of maladjustment, new maladjustment of its own which has to be liquidated in turn, thus threatening business with another crisis ahead. Particularly, our story provides a presumption against remedial measures which work through

Rebuttal to the Pain Caucus



and Its Collapse

Deviation from 2007:I Shares of Potential GDP



Long-Run: 2005-08

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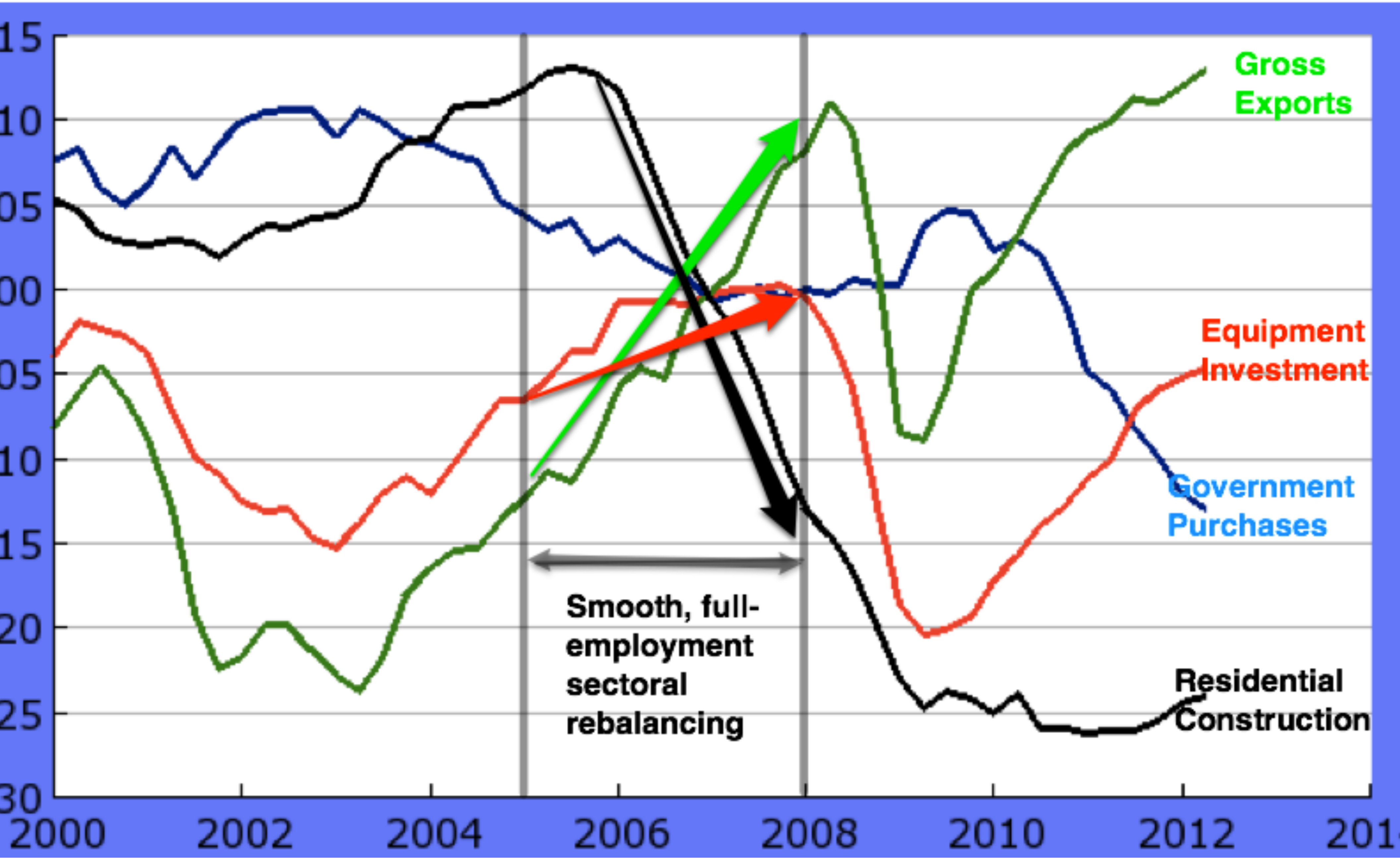
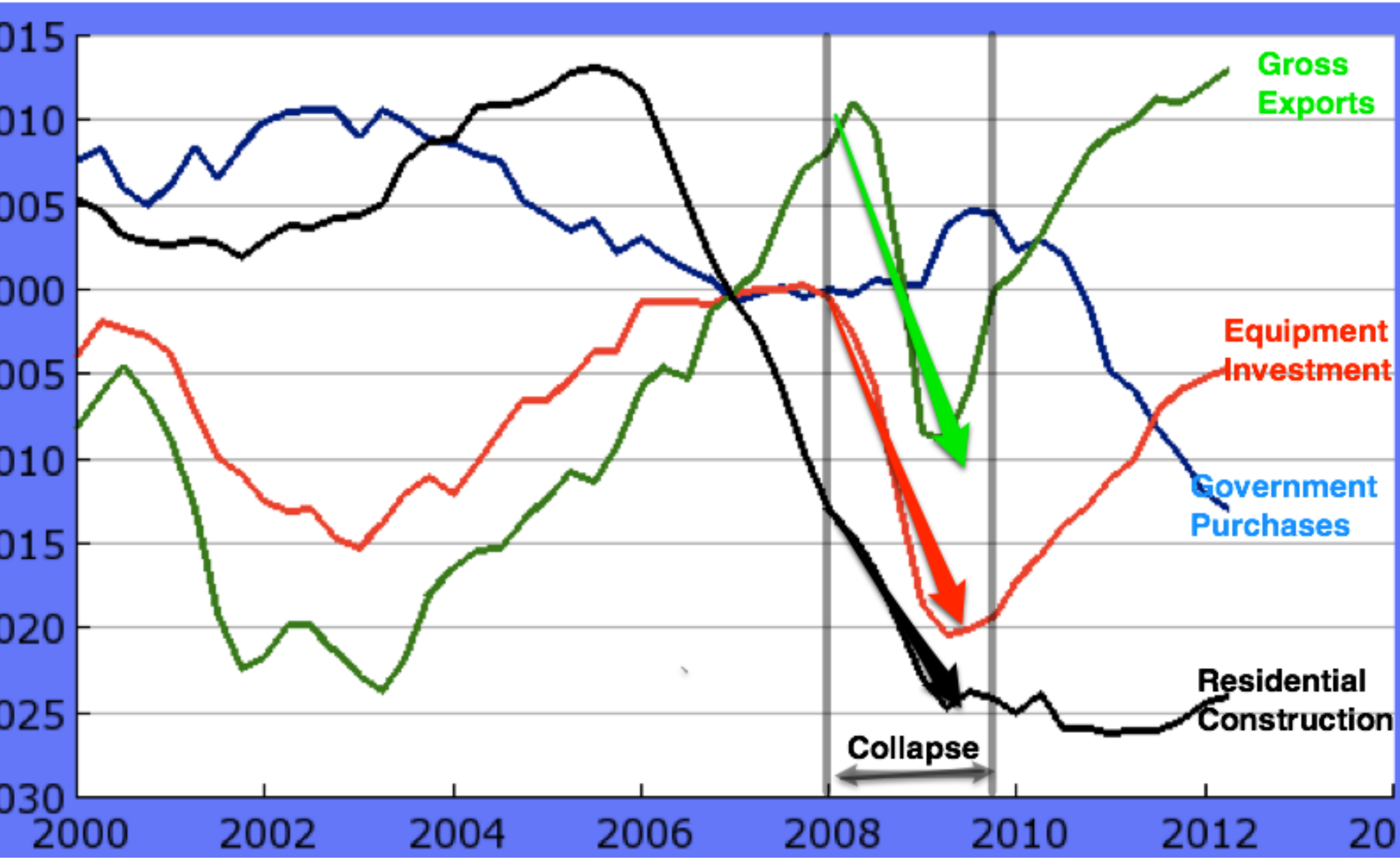


Short-Run: 2008-9

Deviation from 2007:I Shares of Potential GDP



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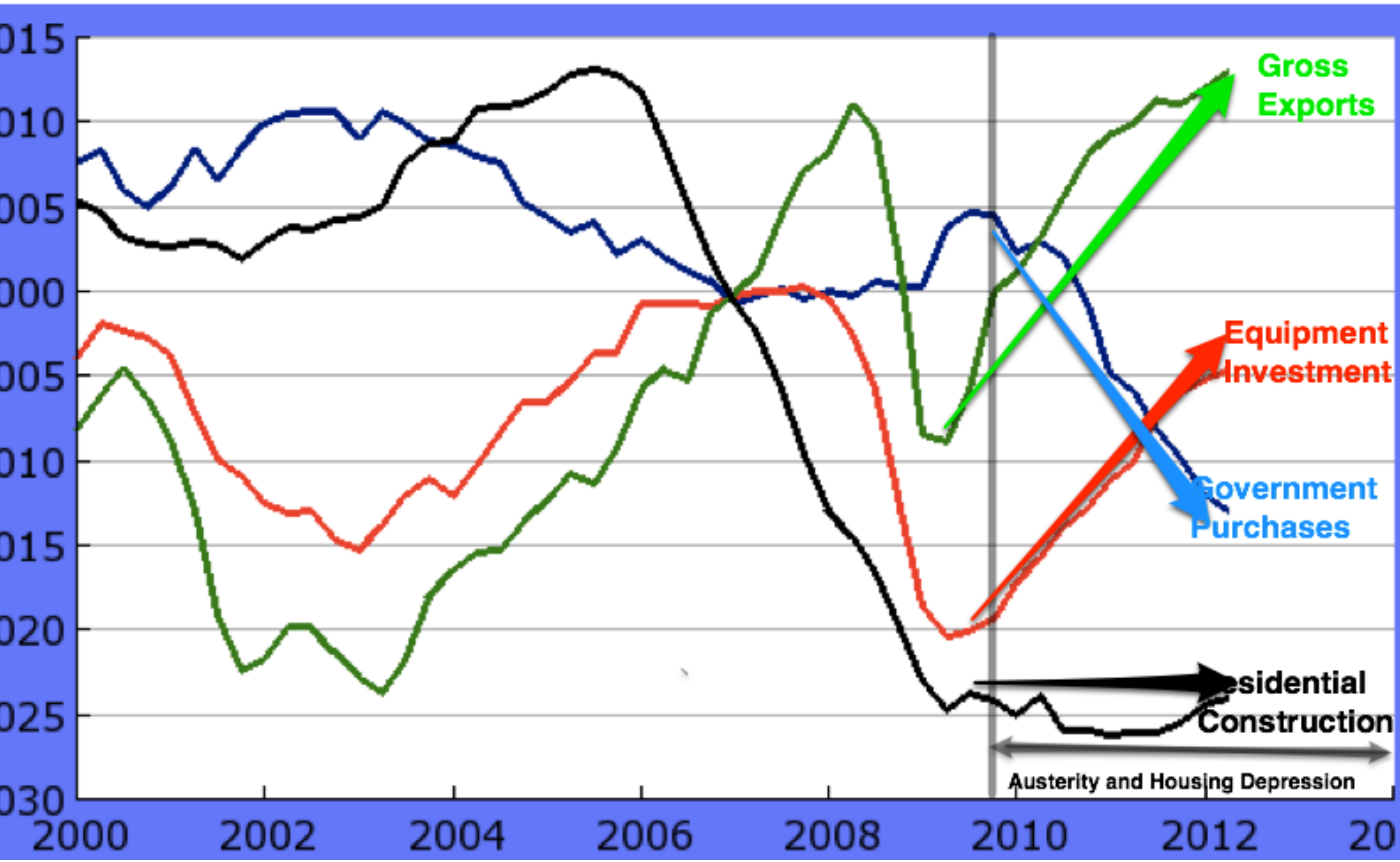

Conclusion

- What arguments are left against pulling spending forward from the future into the present and pushing taxes from the present into the future more than we are doing?
  - That interest rates will spike, and make it expensive when we rollover our debt
  - That the costs of us running high debt are much larger than found by Reinhart-Rogoff
  - That our political system cannot do the job of making sane policy

Is Monetary Policy the Best Expansionary Policy?