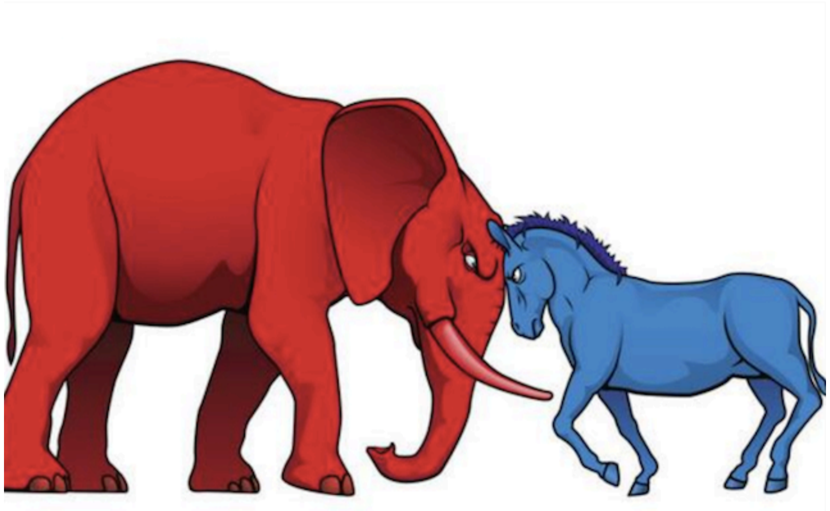
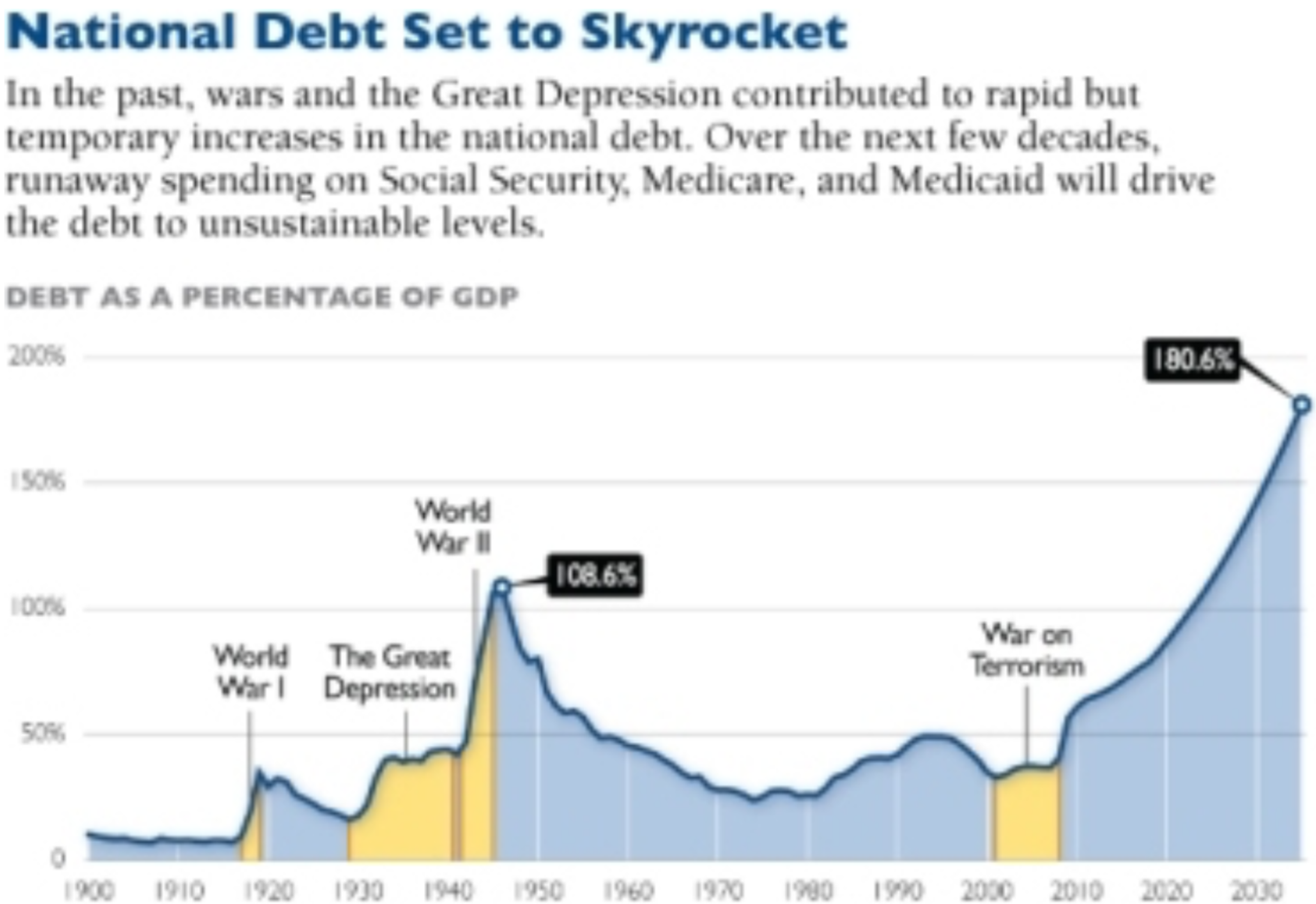
What if They're Both Wrong?

An Insider's Look at Washington's Battle Over Debt and Deficits



Stephanie Kelton, Ph.D.
Chief Economist, U.S. Senate Budget Committee (Democratic Staff)
25th Annual Minsky Conference
April 12, 2016

We Already Built the Wall

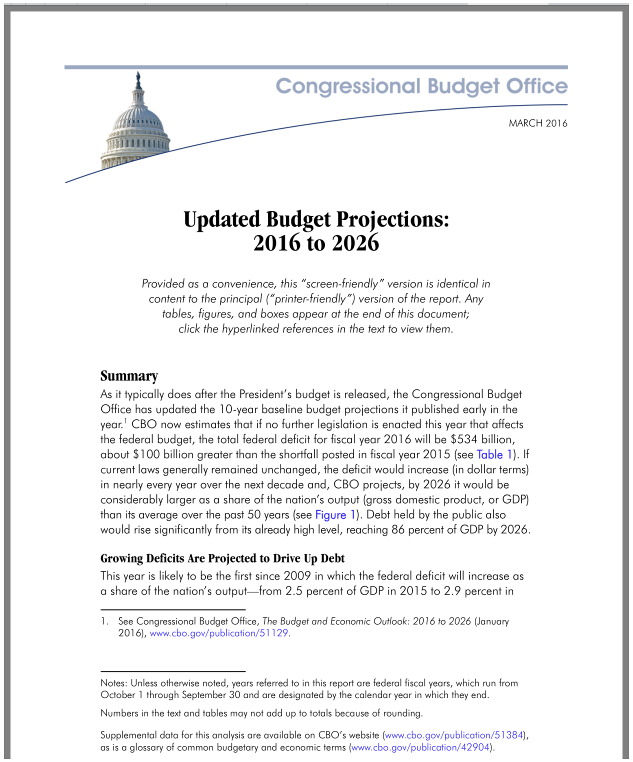


Source: Congressional Budget Office

The Gate Keepers

One important effect of such deficits would be a burgeoning amount of debt held by the public. In 10 years, debt held by the public would equal 86 percent of GDP — more than twice its average over the past five decades. Debt that high—and heading higher—would have significant negative budgetary and economic consequences (see Figure 2):

- Once interest rates returned to more typical, higher levels, federal spending on interest payments would increase substantially.
- Because federal borrowing reduces national saving over time, the nation's capital stock ultimately would be smaller, and productivity and total wages would be lower, than would be the case with lower debt.
- Lawmakers would have less flexibility to use tax and spending policies to respond to unexpected challenges.
- The probability of a fiscal crisis in the United States would increase. Specifically, the risk would rise of investors' becoming unwilling to finance government borrowing unless they were compensated with significantly higher interest rates. If that occurred, interest rates on federal debt would rise suddenly and sharply relative to rates of return on other assets.


Congressional Budget Office

MARCH 2016

Updated Budget Projections: 2016 to 2026

Provided as a convenience, this "screen-friendly" version is identical in content to the principal ("printer-friendly") version of the report. Any tables, figures, and boxes appear at the end of this document; click the hyperlinked references in the text to view them.

Summary

As it typically does after the President's budget is released, the Congressional Budget Office has updated the 10-year baseline budget projections it published early in the year.[1] CBO now estimates that if no further legislation is enacted this year that affects the federal budget, the total federal deficit for fiscal year 2016 will be $534 billion, about $100 billion greater than the shortfall posted in fiscal year 2015 (see Table 1). If current laws generally remained unchanged, the deficit would increase (in dollar terms) in nearly every year over the next decade and, CBO projects, by 2026 it would be considerably larger as a share of the nation's output (gross domestic product, or GDP) than its average over the past 50 years (see Figure 1). Debt held by the public also would rise significantly from its already high level, reaching 86 percent of GDP by 2026.

Growing Deficits Are Projected to Drive Up Debt

This year is likely to be the first since 2009 in which the federal deficit will increase as a share of the nation's output—from 2.5 percent of GDP in 2015 to 2.9 percent in

1. See Congressional Budget Office, *The Budget and Economic Outlook: 2016 to 2026* (January 2016), www.cbo.gov/publication/51129.

Notes: Unless otherwise noted, years referred to in this report are federal fiscal years, which run from October 1 through September 30 and are designated by the calendar year in which they end.

Numbers in the text and tables may not add up to totals because of rounding.

Supplemental data for this analysis are available on CBO's website (www.cbo.gov/publication/51384), as is a glossary of common budgetary and economic terms (www.cbo.gov/publication/42904).

What Everyone "Knows" For Sure

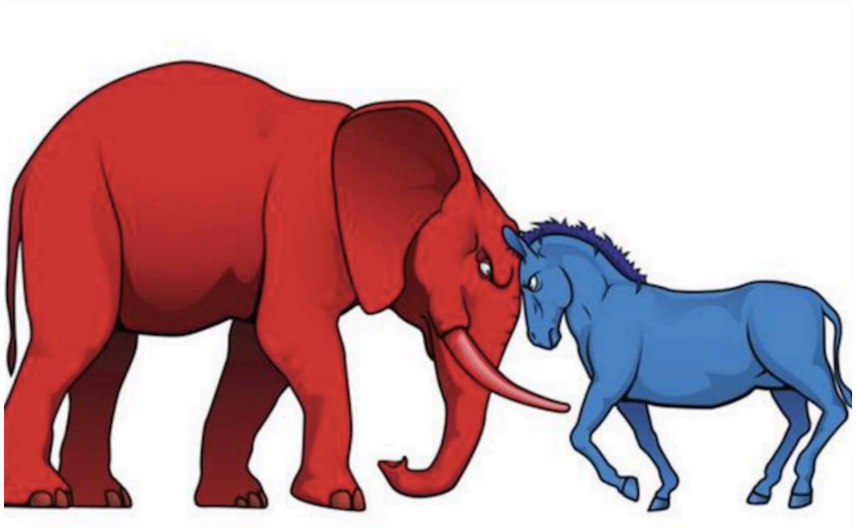
And, Of Course, Entitlements Are to Blame

In CBO's baseline, deficits rise because growth in revenues over the next 10 years is outpaced by increases in spending—particularly for Social Security, Medicare, and interest payments on the federal debt. The deficit remains at roughly 2.8 percent of GDP through 2018 but climbs to 4.9 percent of GDP by 2026. The cumulative deficit projected for the 2017–2026 period is $9.3 trillion.

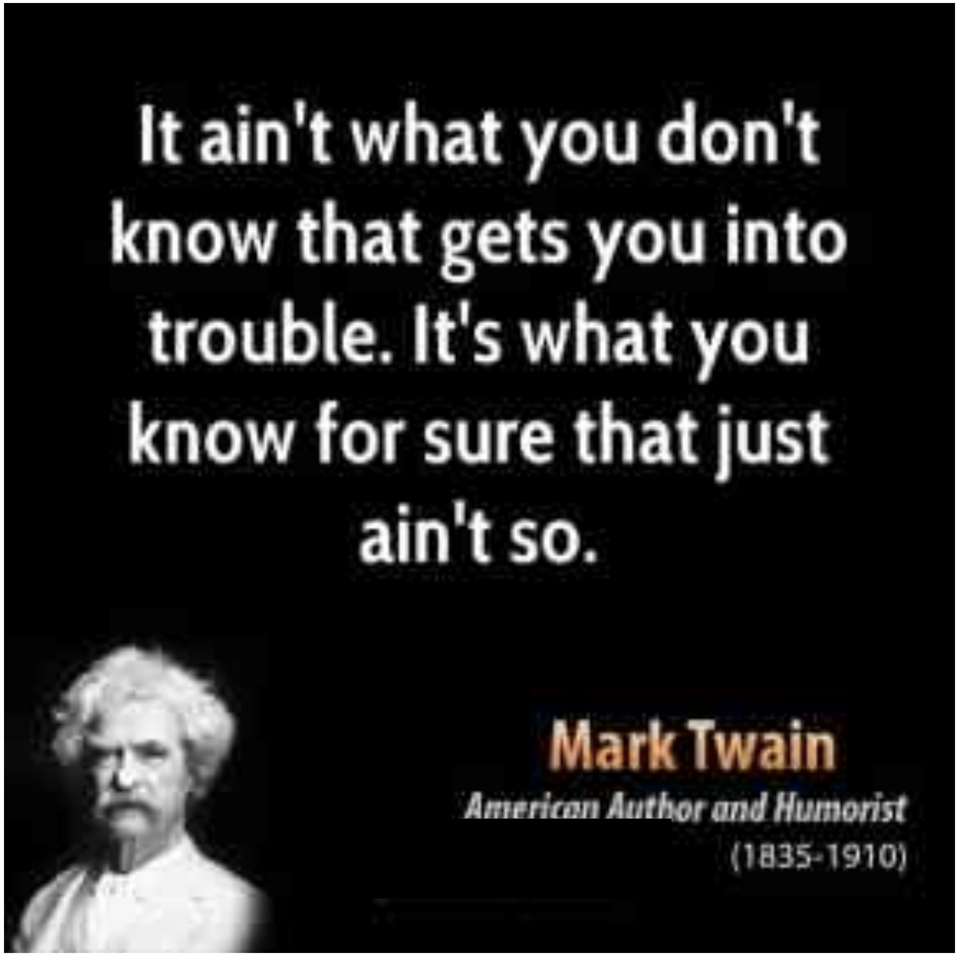
The Battle is Over *How* to Fix It

- **Democrats** say, "We have a **revenue** problem!"

- **Republicans** say, "We have a **spending** problem!"



What If It Just Ain't So?



What if …

- Deficits don't drive up interest rates and **=> crowding out**
- What if the debt doesn't burden the **next generation**
- **China** really isn't our banker
- There is no **long-term** debt problem
- We're **looking** at this all wrong
- We **need** the government to be in deficit even in so-called good times

“Government deficits sustain aggregate profits when private market determinants of aggregate profits would lead to a fall in aggregate profits...Government deficits sustain and even increase business profits whenever private investment turns down..”

~H.P. Minsky

Is that Responsible?

The Hawks Don't Think So

- A deficit hawk opposes deficit spending on principle
- Want immediate cuts and austerity to reduce deficits
- Often favor gold standard or 100% reserve backing
- Would legislate rules to mandate balanced budgets

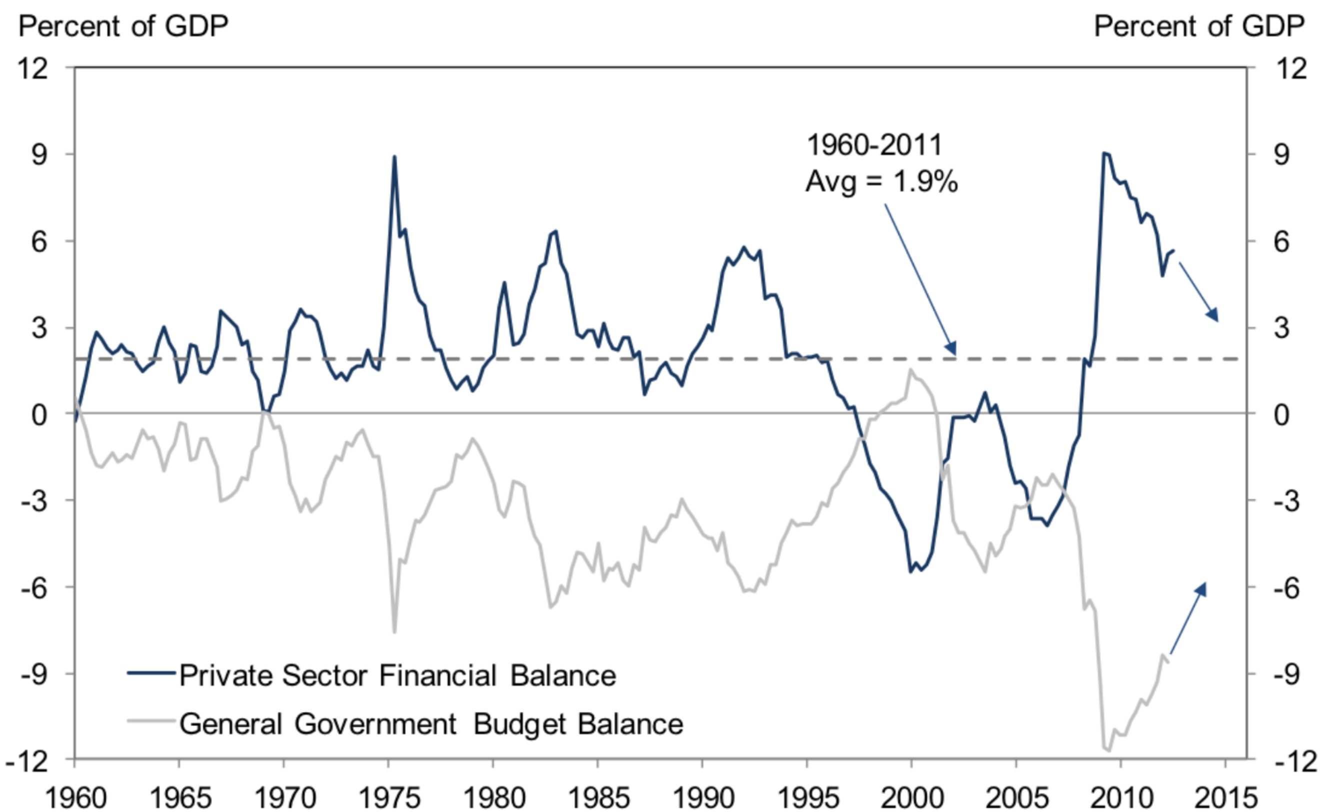
The Doves Don't Think So

- A deficit dove supports limited deficit spending in tough economic times
- Want the budget balanced over the business cycle
- Support rules to limit the size of the deficit
- Prefer to wait until after the economy begins to recover before imposing austerity

Another Way to Look at the Deficit?

- $G > T$
- Suppose
  $G = \$100$ and $T = \$90$
- The "deficit" is $10
- But wait!
- That $10 has to go somewhere
- A government deficit is a **surplus** in some other part of the economy

What *Almost* Everyone Is Missing

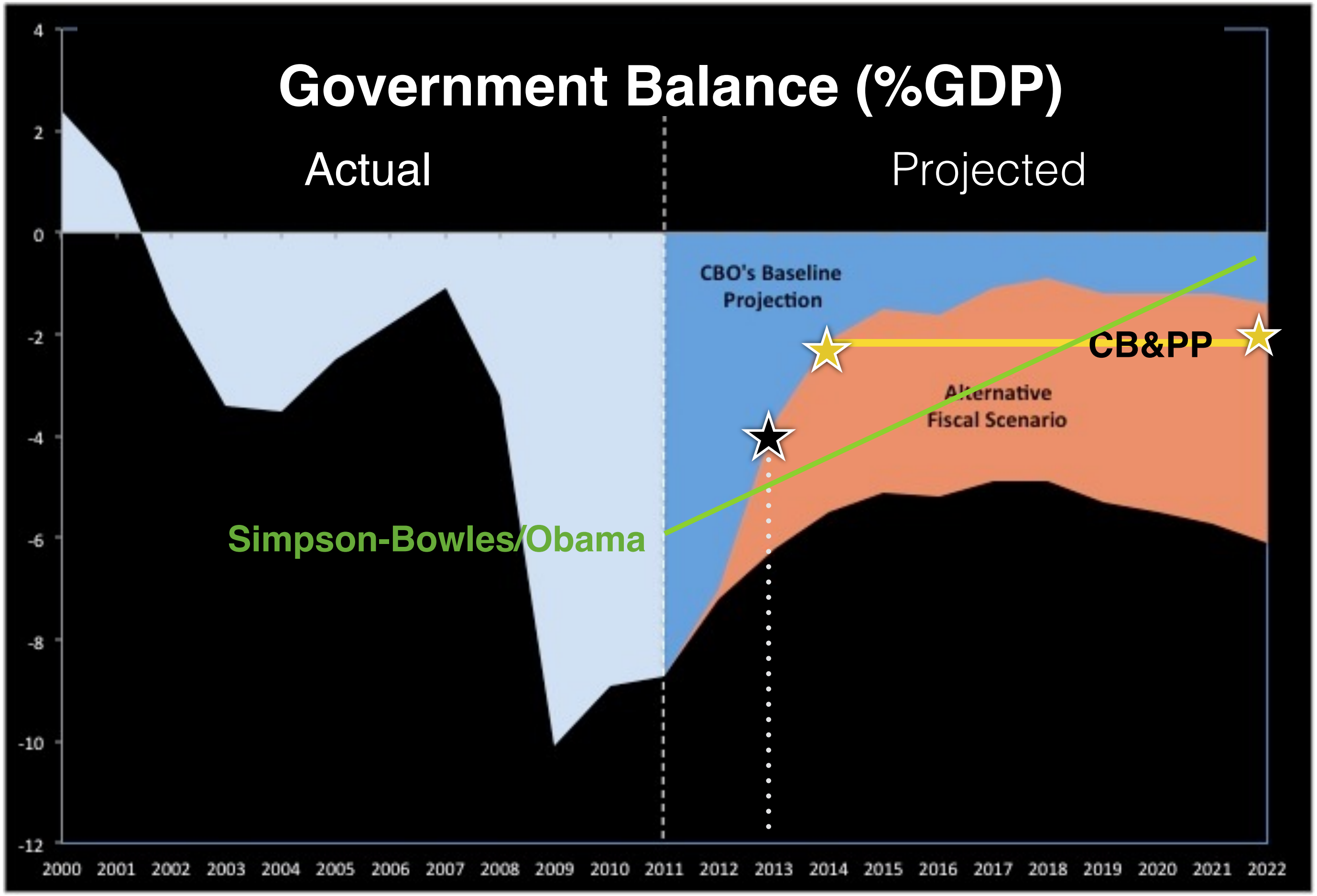


Source: Department of Commerce. GS Global ECS Research.

Now Examine the Deficit Obsession

- At the height of the Great Recession, budget deficits exceeded **$1 trillion**
- President **Obama** announced that the U.S. was "out of money"
- Established a deficit-reduction **commission**
- Simpson-Bowles proposed more than **$4 trillion** in deficit reduction over 10 years

"I'll wash Mitch McConnell's car.
I'll walk John Boehner's dog."
~President Obama


Government Balance (%GDP)
Actual
Projected
CBO's Baseline Projection
Alternative Fiscal Scenario
CB&PP
Simpson-Bowles/Obama
4
2
0
-2
-4
-6
-8
-10
-12
2000
2001
2002
2003
2004
2005
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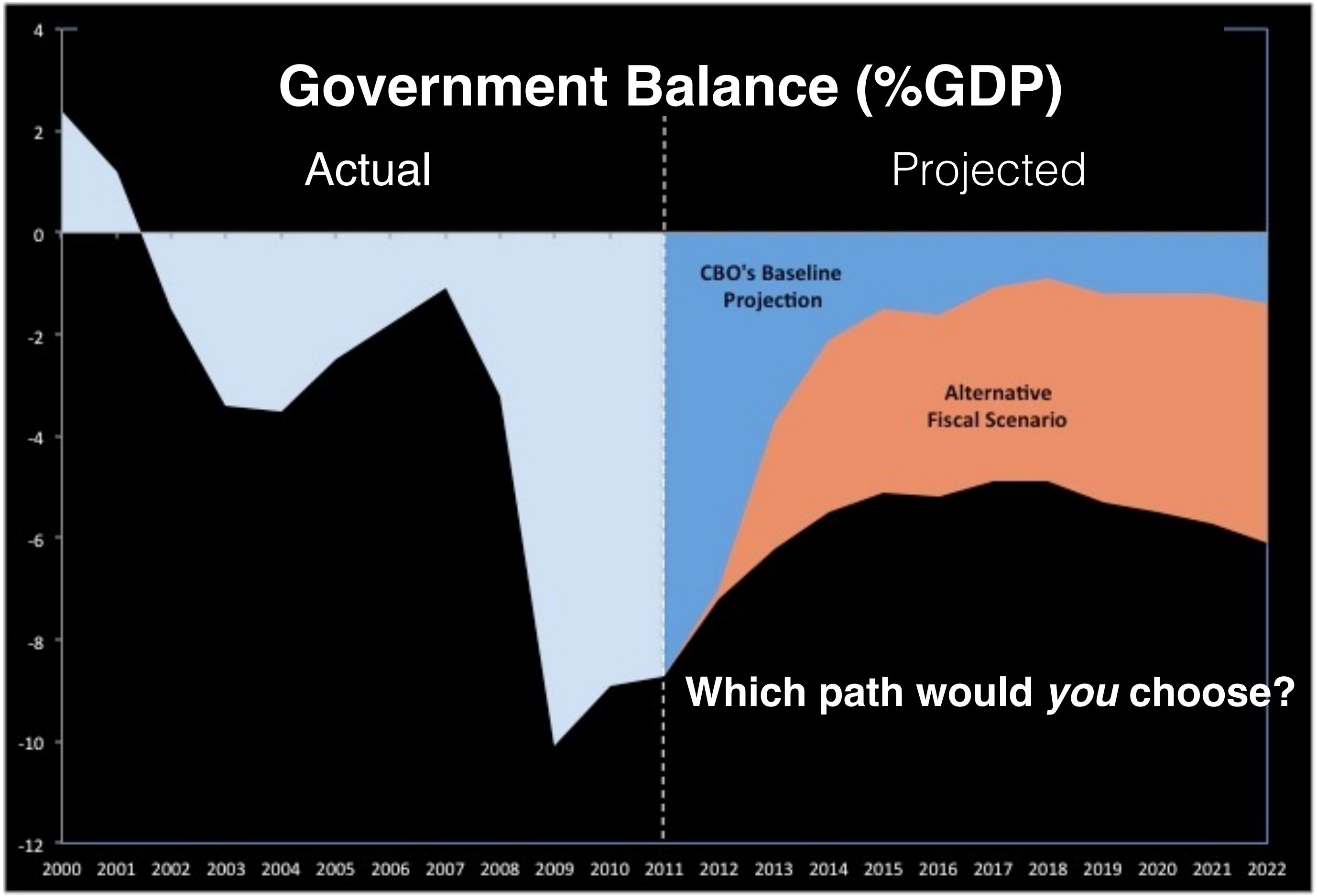
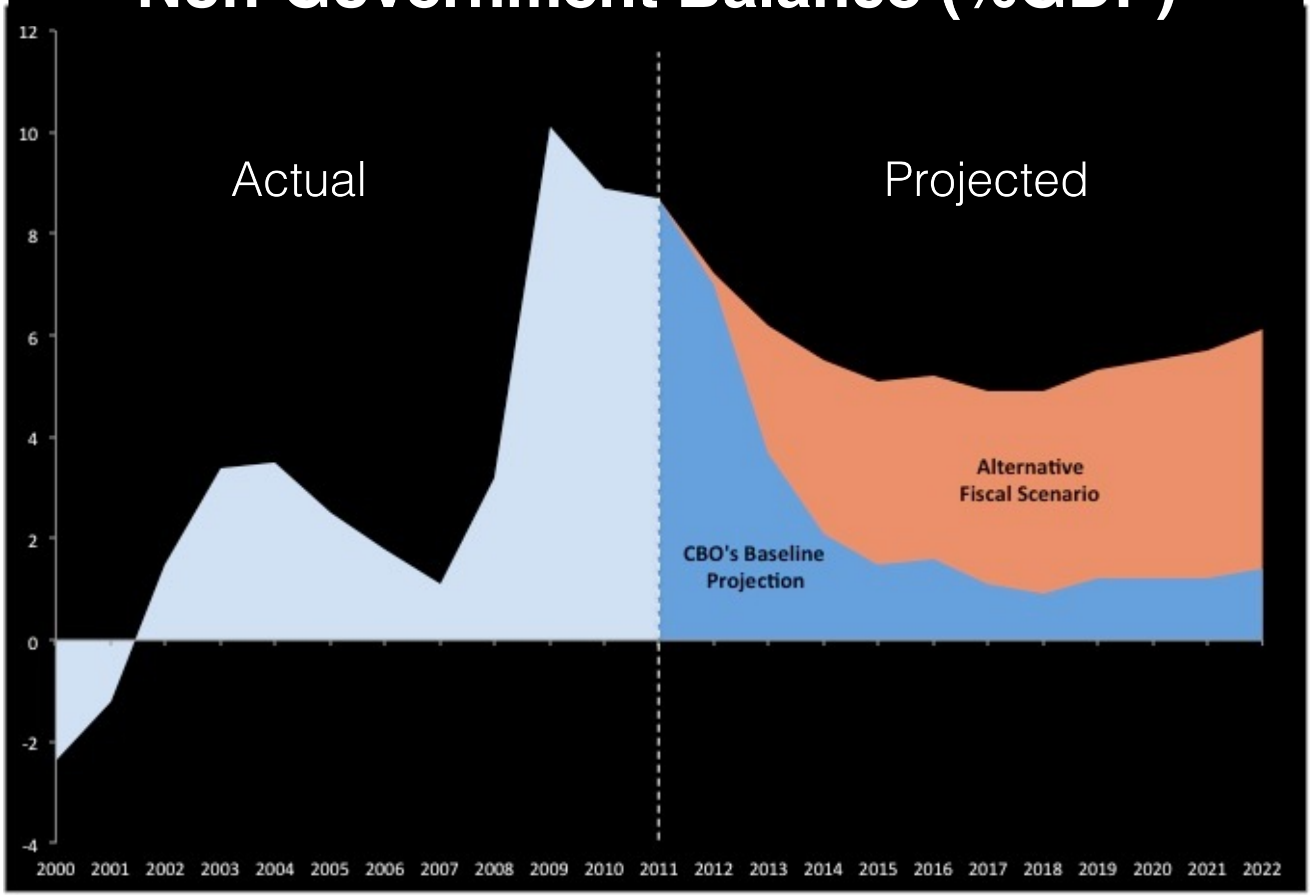
2020
2021
2022

Perspective

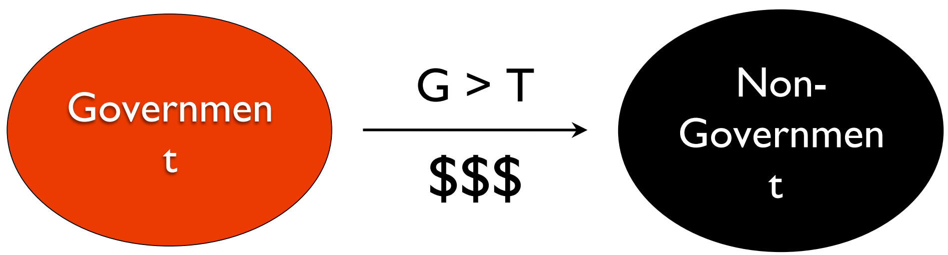
Matters


Government Balance (%GDP)
Actual
Projected
CBO's Baseline Projection
Alternative Fiscal Scenario
Which path would *you* choose?
4
2
0
-2
-4
-6
-8
-10
-12
2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 2022

Non-Government Balance (%GDP)



A Simple and Indisputable Accounting Fact



The Government Deficit = The Non-Government Surplus!

or

Their red ink is Our black ink!

Threat to corporate profits

If projected tax hikes and spending cuts take effect in 2013, profits could take a hit.

BY JORDAN ALEXIEV, CFA, SENIOR RESEARCH ANALYST, ASSET ALLOCATION RESEARCH, FIDELITY VIEWPOINTS – 08/17/2012

Market Analysis | Stocks

Without Congressional action, around $600 billion of expiring tax cuts, new taxes, and automatic spending cuts are set to take effect at the beginning of 2013.[1] These circumstances—labeled the fiscal cliff—have investors wondering what the implications will be for the U.S. economy and the stock market.

Key takeaway

- *Our base case scenario is that the full fiscal cliff will not occur, though the probability is not zero.*
- *Our research indicates that if the full fiscal cliff occurred, the decline in government spending could lower aggregate profits by as much as 31%.*
- *Near-term caution regarding equity market performance may be warranted.*

Based on our research, in the worst case scenario, the full fiscal cliff could impact a key source of corporate earnings and result in a significant decline in aggregate profits. With this outcome in the spectrum of possibilities, escalating stock market volatility would not be a surprise. Markets typically begin pricing in the potential for disappointment in advance of major developments. However, this has not been the case to date. In fact, based on implied and actual volatility metrics

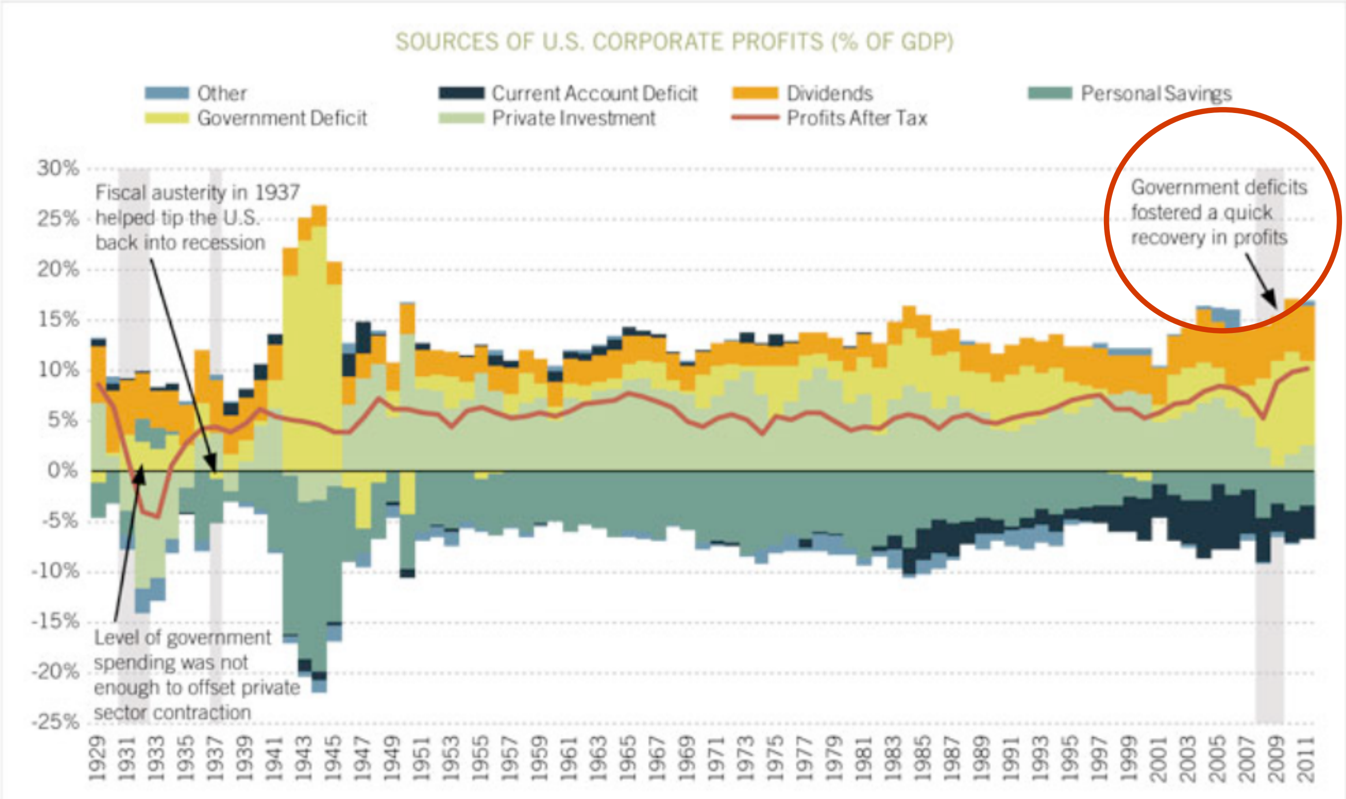
Kalecki-Levy Profit Equation

Decreased government deficit spending would contribute to a 31% drop in profits.

Profit Equation	Corporate Profits		Est. 2012* ($Bn)	Est. 2013** ($Bn)
Fixed investment	+			
Capital consumption allowance	-			
Increase in inventory	+	*Net private investment*	$387	$387
Personal saving	-		-$485	-$485
Government deficit	+		$1,171	$612
Current account deficit	-		-$504	-$504
Dividends	+		$832	$832
Corporate profit taxes	+		$411	$411
= Corporate profits before taxes			**$1,811**	**$1,252**
	Expected change in profits			-31%

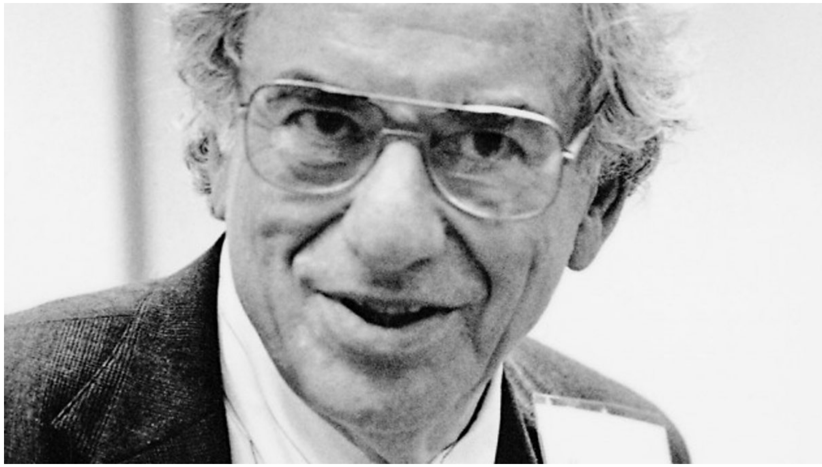
*2011 actual numbers grown by 3.7% (CBO 2012 nominal GDP estimate). **2012 estimated numbers grown by 2.
nominal GDP estimate).
Source: Fidelity Investments

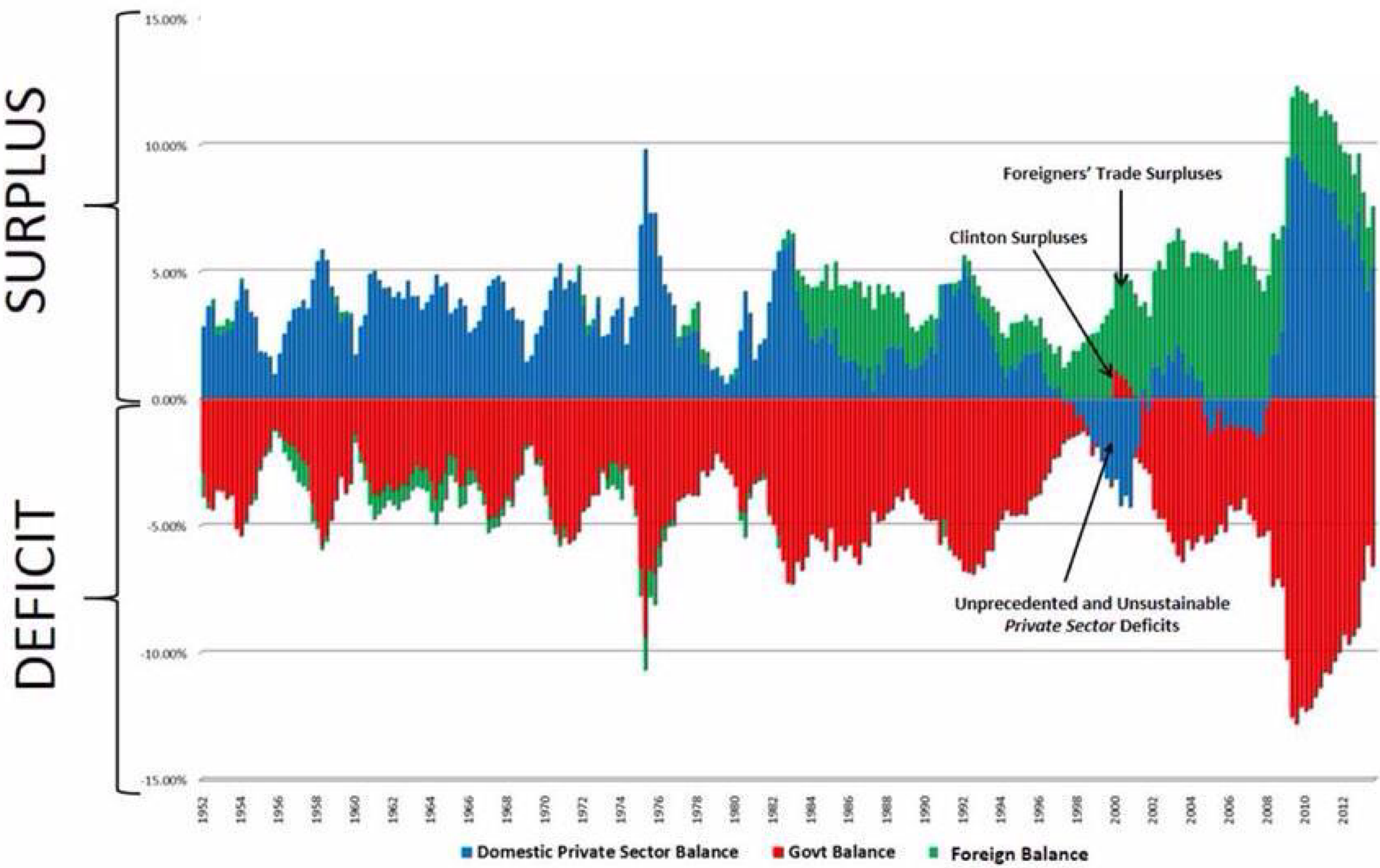
Following a financial crisis, when the private sector has stopped investing, government deficits have lifted corporate profits.



Why "It" Didn't Happen Again

- "[T]he ability of the Federal Government and its agencies to contain and offset the tendency of our capitalism to deteriorate into serious depressions." -HPM
- Big Government
- Big Bank




SURPLUS
DEFICIT
15.00%
10.00%
5.00%
0.00%
-5.00%
-10.00%
-15.00%
Foreigners' Trade Surpluses
Clinton Surpluses
Unprecedented and Unsustainable
Private Sector Deficits
1952
1954
1956
1958
1960
1962
1964
1966
1968
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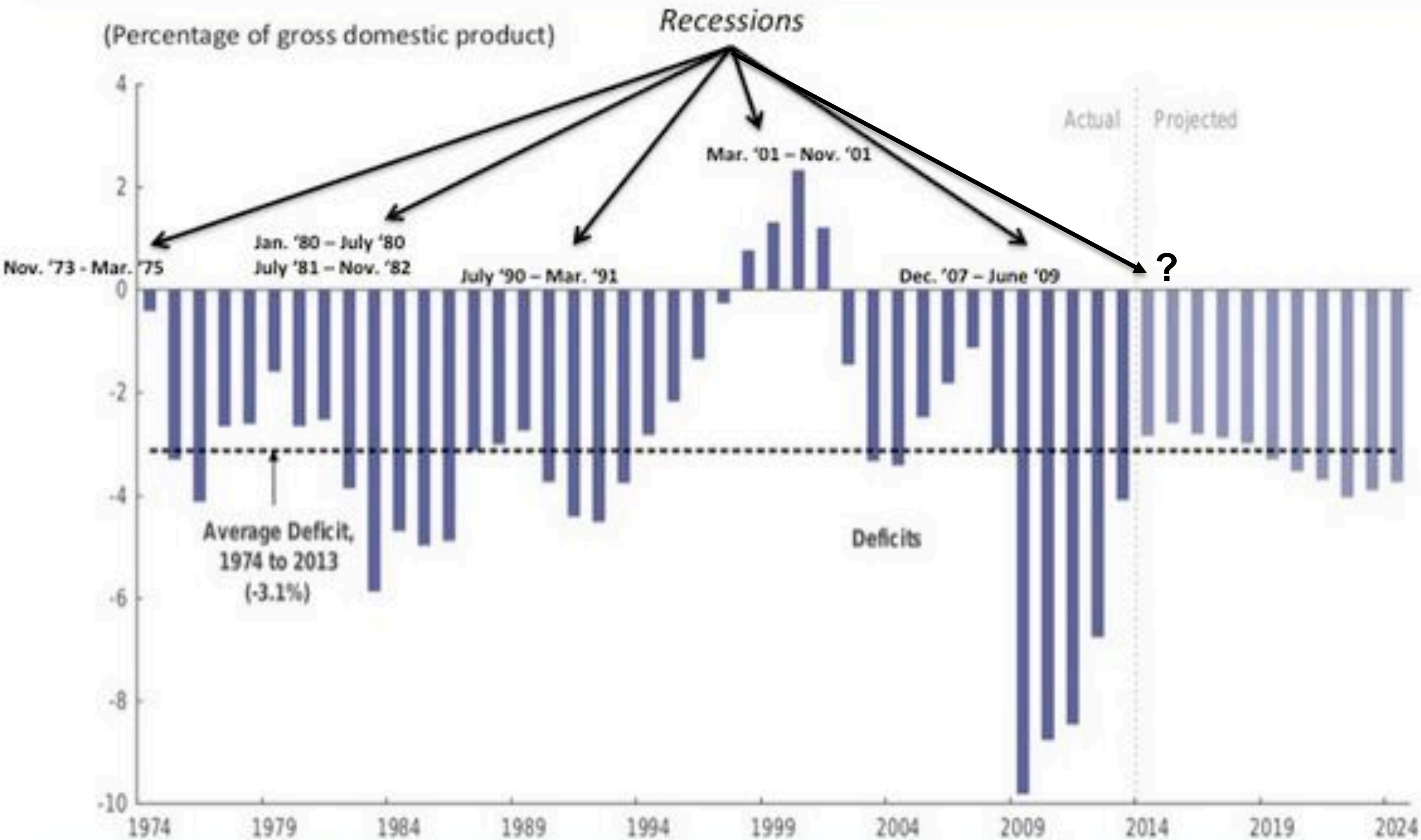
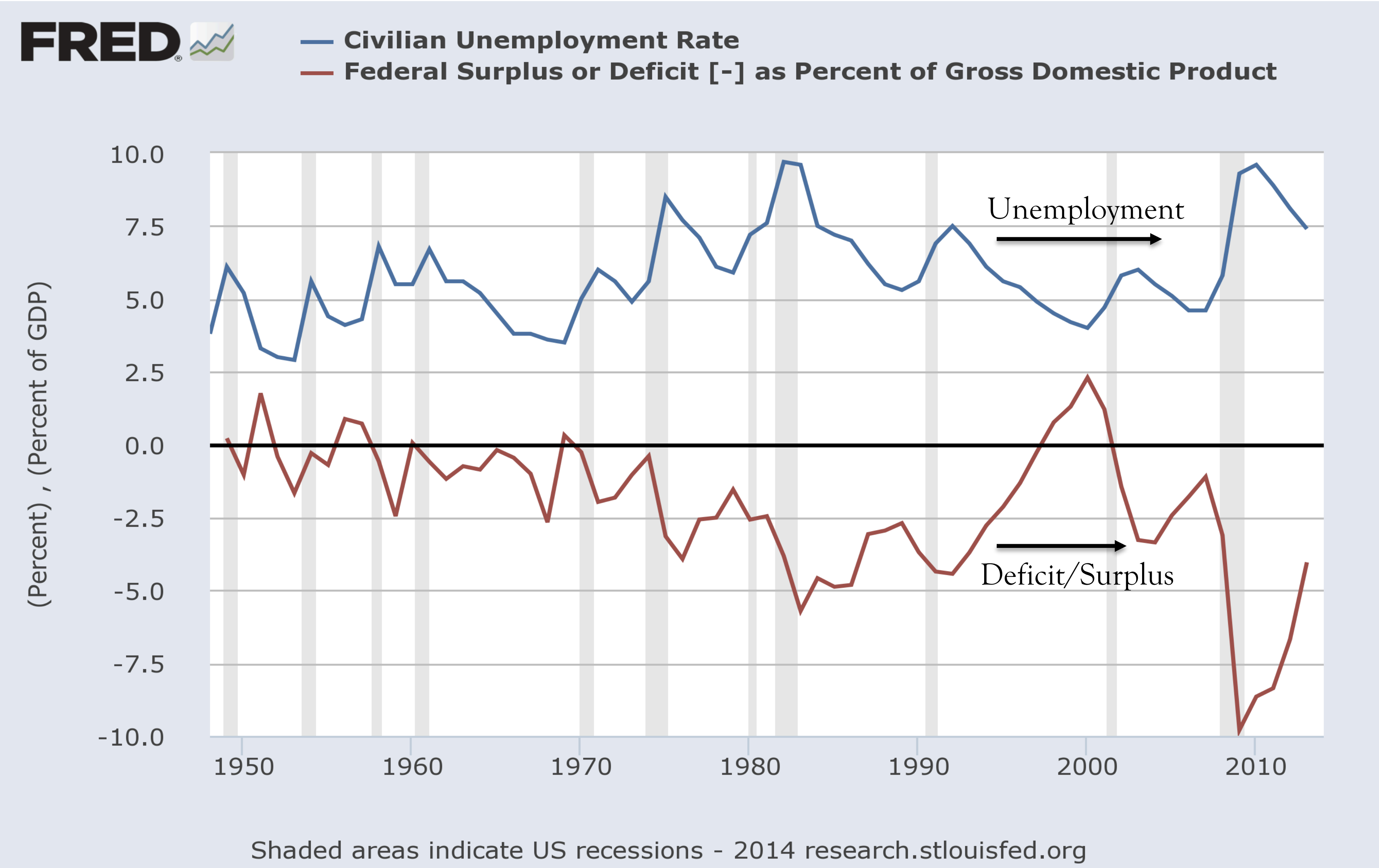
2008
2010
2012
Domestic Private Sector Balance
Govt Balance
Foreign Balance

Deficits Can Be Too Big or Too Small



Deficits Are Mostly Automatic

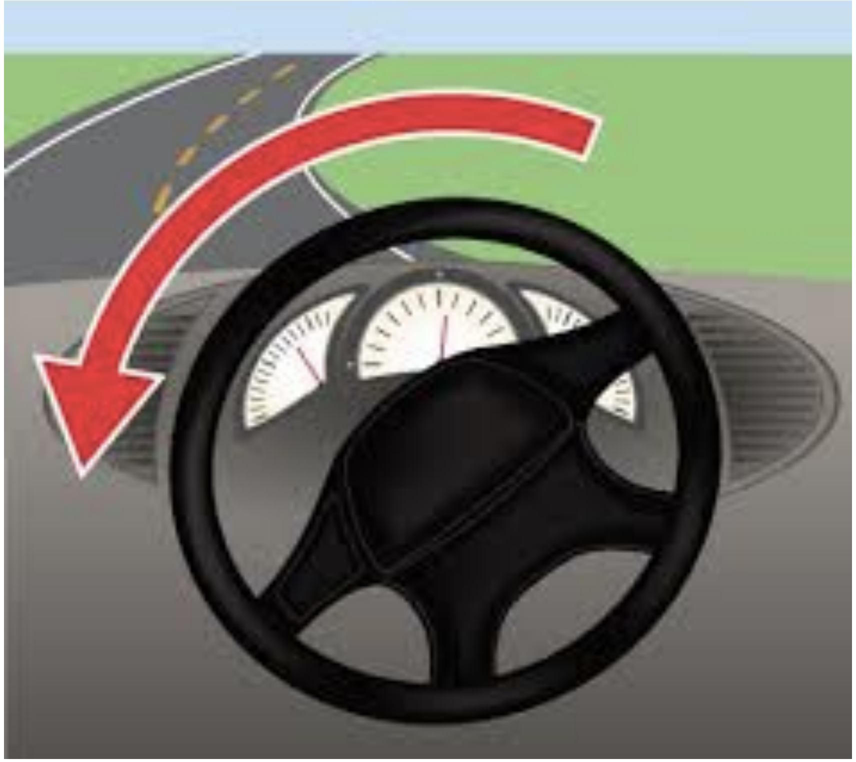


“Government tax and spending policies, which turn from surpluses towards deficits whenever the economy contracts and from deficits to smaller deficits or surpluses whenever price inflation rears its head, has the power to contain both depressing and inflationary potentials of our economy.”

–H.P. Minsky, 1995

Turning Into the Skid

- When the economy starts to **weaken,** unemployment rises and the deficit increases
- The **impulse** is to fight **against** it (with austerity) to keep the deficit in check
- But that only makes things **worse**
- Like turning the **wheel** in the **opposite** direction in skid
- You have to turn **into** the skid to regain **balance**



Awaiting A New Policy Paradigm

"The task before today's economists and public officials is to meet the challenges of the present without forgetting the valuable lessons of the past...the neoclassical economists and the developers of our current political agenda are incapable of leading America into a new period of sustained prosperity."

–HPM, 1995

Who Will Lead?

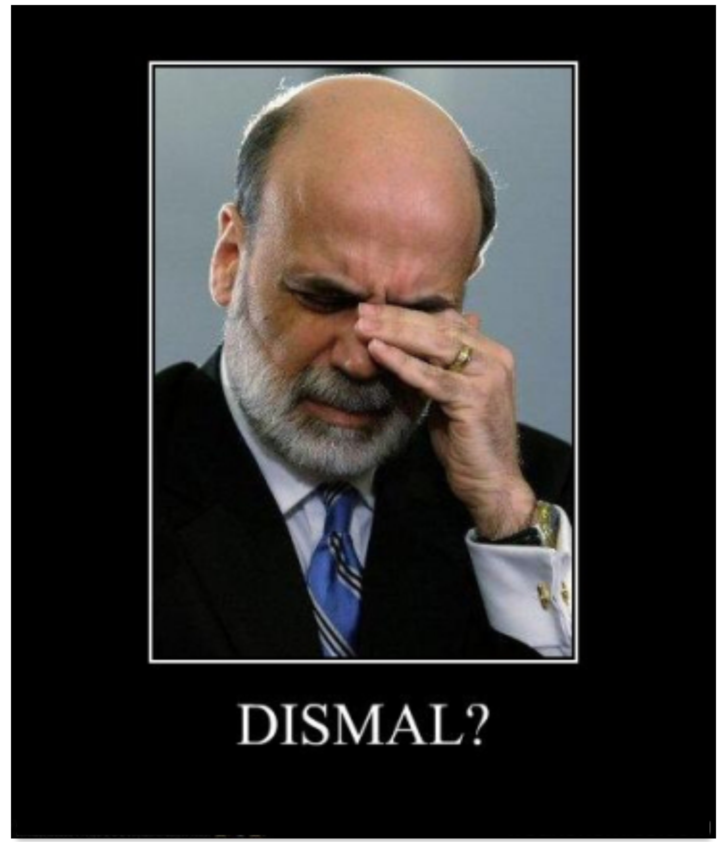
- American politicians have **embraced** economic **myths** and **policies** that have **led to slow recovery**
- There is an **urgent need** for a **different** way of thinking about **money** and **deficit spending**
- There are **big challenges** ahead (infrastructure, education, climate, etc.)
- We need **an economic framework** to complement a more robust challenge to austerity

Budgeting Gimmicks

- Dynamic scoring
- Generational accounting
- Fair Value accounting

Fiscal Outlook

- Era of threatened shutdowns will continue
- Debt ceiling will be more difficult to raise
- House GOP loses seats but Freedom Caucus gains leverage with leadership
- No compromises with Dems
- Might finally abandon budget resolutions
- Or allow them mostly for reconciliation for non-budget purposes
- Likely puts more pressure on the Fed



[T]here is no assurance that capitalist economies, when plunged into downturn, will over any interval revert to what had been normal. Understanding this phenomenon and responding to it seems the central challenge for macroeconomics in this era.... I suspect it will lead to more emphasis on fiscal rather than monetary actions in depressed economies. - Larry Summers, Nov 2, 2015

"If we could come up with better fiscal policy...then that takes the pressure off of us to try to come up with other ways to do it, like through a large balance sheet. It also means we don't have to turn to quantitative easing and other policies as much." - John Williams, SFO Fed, Oct., 2015

“We need to recapture our can do spirit and eliminate from the seats of power those of little faith and of little vision.”

~H.P. Minsky

Thank You!