What if They’re Both Wrong?

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

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25th Annual Minsky Conference
April 12, 2016
We Already Built the Wall

National Debt Set to Skyrocket

In the past, wars and the Great Depression contributed to rapid but temporary increases in the national debt. Over the next few decades, runaway spending on Social Security, Medicare, and Medicaid will drive the debt to unsustainable levels.

DEBT AS A PERCENTAGE OF GDP

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.
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?

It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so.

Mark Twain
American Author and Humorist
(1835-1910)
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
Perspective Matters
Government Balance (%GDP)

Actual

Projected

CBO's Baseline Projection

Alternative Fiscal Scenario

Which path would you choose?
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

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. These circumstances—labeled the fiscal cliff—have investors wondering what the implications will be for the U.S. economy and the stock market.

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:

**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.
Kalecki-Levy Profit Equation

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

<table>
<thead>
<tr>
<th>Profit Equation</th>
<th>Corporate Profits</th>
<th>Est. 2012* ($Bn)</th>
<th>Est. 2013** ($Bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed investment</td>
<td>+</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital consumption allowance</td>
<td>-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase in inventory</td>
<td>+</td>
<td>+ Net private investment $387</td>
<td>$387</td>
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<tr>
<td>Personal saving</td>
<td>-</td>
<td>-$485</td>
<td>-$485</td>
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<tr>
<td>Government deficit</td>
<td>+</td>
<td>$1,171</td>
<td>$612</td>
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<tr>
<td>Current account deficit</td>
<td>-</td>
<td>-$504</td>
<td>-$504</td>
</tr>
<tr>
<td>Dividends</td>
<td>+</td>
<td>$832</td>
<td>$832</td>
</tr>
<tr>
<td>Corporate profit taxes</td>
<td>+</td>
<td>$411</td>
<td>$411</td>
</tr>
<tr>
<td><strong>= Corporate profits before taxes</strong></td>
<td></td>
<td><strong>= Corporate profits before taxes</strong> $1,811</td>
<td>$1,252</td>
</tr>
</tbody>
</table>

*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.

Government deficits fostered a quick recovery in 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
The chart illustrates the trend of various fiscal balances from 1962 to 2012. The y-axis represents the budget balances as a percentage of GDP, ranging from -15.00% to 15.00%. The chart is divided into two parts:

- **Surplus**: This section shows positive balances, indicating that revenue exceeds expenditures.
- **Deficit**: This section shows negative balances, indicating that expenditures exceed revenue.

Key observations include:
- **Foreigners’ Trade Surpluses**: A peak in the late 2000s.
- **Clinton Surpluses**: A significant surplus during the Clinton administration.
- **Unprecedented and Unsustainable Private Sector Deficits**: A period of extreme deficits in the early 2000s.

The chart also highlights the breakdown of the budget balances into three categories:
- **Domestic Private Sector Balance**
- **Govt Balance**
- **Foreign Balance**

The color coding is as follows:
- Domestic Private Sector Balance: Blue
- Govt Balance: Red
- Foreign Balance: Green
Deficits Can Be Too Big or Too Small

(Percentage of gross domestic product)

Recessions

- Jan. '80 – July '80
- July '81 – Nov. '82
- July '90 – Mar. '91
- Dec. '07 – June '09

Average Deficit, 1974 to 2013 (-3.1%)

Actual
Projected


CONGRESSIONAL BUDGET OFFICE
Deficits Are Mostly Automatic

Shaded areas indicate US recessions - 2014 research.stlouisfed.org
“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!