EconoFact Chats: U.S. Fiscal Policy and the Current State of the Economy

Maurice Obstfeld, UC Berkeley

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Michael Klein:

Hello everyone, welcome to Econofact Chats. I'm Michael Klein, executive editor of Econofact, a non-partisan web based publication of the Fletcher School at Tufts University. On Econofact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein:

Well, now it's official. The National Bureau of Economic Research, the arbiters of business cycles, declared on June 8th that the recession began in February. This will not come as a surprise. Well, perhaps more surprisingly, there was a decrease in the reported unemployment rate for May, even though the level is still above anything we've seen since the Great Depression.

Michael Klein:

This has fueled a debate. Is it time to cut back government support for the economy? Or, would any moves to fiscal consolidation now, or in the coming months, be premature? To address these and other questions, I'm very pleased to be speaking with Maurice Obstfeld, of UC Berkeley. Maury is widely recognized as one of the world's leading experts in international economics. He has served as member of President Obama's Council of Economic Advisors, and from 2015 to 2018, he served as chief economist at the International Monetary Fund.

Michael Klein:

Maury, welcome to Econofact Chats.

Maurice Obstfeld:

It's great to be here, Michael.

Michael Klein:

It's wonderful to have you on. Maury, at the end of January 2020, most people expected the economy to continue on its path of slower, but still somewhat steady growth. Then, the bottom fell out. Has there ever been anything that matches the speed and depth of the decline in GDP that we saw over the past few months?

Maurice Obstfeld:

Not in the post-war period, and not in the United States. One does think of the Great Depression, one thinks of the case of Greece during the Euro crisis, but those were driven by demand side shocks. And what we've seen in the US, and in the world recently, has been a big supply side shock, as people have isolated.

Michael Klein:

So there a lot of implications of this, obviously. You and I published an Econofact memo about the fiscal implications of it. What's been happening to the government's budget deficit?

Maurice Obstfeld:

Well, it's exploded. In 2019, the US deficit was 4.6% of GDP, and in 2020 it's forecast by the Congressional Budget Office to be almost 18% of GDP.

Michael Klein:

Have you ever seen numbers like that?

Maurice Obstfeld:

That's a huge change.

Michael Klein:

Have we ever seen numbers like that, 18%, for the US?

Maurice Obstfeld:

Not in recent memory, no. Not ever.

Michael Klein:

Yeah. Actually, the 4.6% was kind of high, too, right? Given that the economy wasn't in a recession at the end of 2019.

Maurice Obstfeld:

Well, the Administration had pushed for, and succeeded in getting a tax cut in the situation where the economy was, actually, doing quite well. It was a pro-cyclical fiscal expansion. So that led to a large deficit, that was already pushing public debt upward.

Michael Klein:

So you mentioned debt. Can you just briefly explain for our listeners the link between the budget deficit and the government's debt?

Maurice Obstfeld:

Yeah. When the government has to spend more than it takes in in taxes, including what it has to pay to service the interest on it's existing debt, it needs to borrow in the markets, and it does so by issuing more debt. So this accumulation of deficits drives the public debt upward.

Michael Klein:

You mentioned having to borrow in the markets. So the interest rate, then, is important, as a determinant of the size of the debt, and the ability to manage it as well, right?

Maurice Obstfeld:

Absolutely.

Michael Klein:

So it's a little bit like somebody who has credit card debt, their ability to handle it depends on both what their income would be, but also what interest rate they'll have to pay on the balances they carry forward from previous bills. Interest rates are really low now, aren't they?

Maurice Obstfeld:

They are very low. The Fed had started to raise them gingerly at the end of 2015, after the last financial crisis. But now, they've been slashed effectively to zero at the short end, and longer term rates are low, also.

Michael Klein:

And Jerome Powell has said he's going to keep them very low for the foreseeable future, right?

Maurice Obstfeld:

Yeah, he gave a press conference a couple of days ago where he promised no interest rate increases until the end of 2022, at the earliest.

Michael Klein:

So does that ease a burden on servicing the government debt somewhat?

Maurice Obstfeld:

Well, absolutely. If the Federal government can borrow at super low interest rates, and at the moment even the rate on the 30 year treasury is below 1.5%, then that makes it much easier to sustain a larger public debt.

Michael Klein:

But, going back to the analogy of somebody with credit card debt, it also depends on what their income stream is like in the future. The analogous thing here is the economy's GDP growth rate, right?

Maurice Obstfeld:

Oh, absolutely. That's why, when you take out a mortgage, the lender will want to know what your income is, they want to look at your pay stubs, they want to look at your bank balances and all that information, to assess your ability to pay. So it's not just the rate of interest, it's your ability to generate income to meet those interest payments.

Michael Klein:

So that's looking to the future, and there's a saying in economics that I know you know. If you're going to forecast, forecast often. But nonetheless, what are people thinking about the potential growth rate of GDP for America over the next few years?

Maurice Obstfeld:

Well, there's also the Yogi Berra remark, that "prediction is difficult, especially about the future."

Maurice Obstfeld:

At the moment, it's particularly difficult to forecast, because we are in an unprecedented type of recession. It's likely that the recovery will be slow, there's a lot of uncertainty about whether there will be a second wave of COVID, and there's huge uncertainty about what will happen to inflation. And of course, if you want to look at nominal GDP, the amount of dollars the GDP generated each year, it's the product of real GDP, the amount of real goods and services the economy produces, and the price of those goods and services. So in terms of both of those components, there's a lot of uncertainty.

Maurice Obstfeld:

Some people feel that, with the highest unemployment rate since the Great Recession, there will be deflation. Other people forecast that, with the Fed expanding its balance sheet to unprecedented levels, and with the expansion of government debt, there will be inflation. We really don't know what's going to happen.

Maurice Obstfeld:

You know, if inflation returns to the Fed's 2% target within a couple of years, if a real GDP returns to its longterm growth rate, which is something like 1.6, 1.7, 1.8 percent per year, then we'll have nominal GDP growth of at least 3.5%. That's way above the forecast interest rates.

Michael Klein:

So that would put us in a better situation, with respect to the debt coming down over time.

Maurice Obstfeld:

Right. Economists tend to look at the debt GDP ratio because, again going back to that mortgage analogy, the more income there is, the easier it is to raise the resources to pay the debt. So if we have this denominator in debt over GDP rising rapidly over time, that could offset some of the interest costs of the debt, and that would make it easier to bring the debt to GDP ratio down as time passes, even without big rises in taxes, or cuts to government spending.

Michael Klein:

You pointed out that the times when we've seen these big increases in government debt relative to GDP have been after national emergencies, or things like war. Can you talk a little bit about, in the wake of World War II, what was the debt to GDP ratio like? And, what happened to it over the next 10 or 15 years?

Maurice Obstfeld:

Yeah, well there are two major exceptions to the regularity just cited, about wars driving sharp increases in the debt over GDP. One of those was the Reagan era tax cuts, and the other is the global financial crisis. But, with neither of those did debt reach the ratio we saw at the end of World War II, which is 106% of GDP.

Maurice Obstfeld:

Now, we are clearly headed there again. CBO forecasts for debt, at the end of this, is 101% of GDP, and it will surely rise higher.

Michael Klein:

The forecast in December was 80% or something, right?

Maurice Obstfeld:

Yeah, it was 79%, so that's been a huge change.

Michael Klein:

Right.

Maurice Obstfeld:

That's partially the government projected deficits, but that's also partially the projected fall in GDP this year for the US, which is likely to be in the neighborhood of 6%.

Michael Klein:

So both the numerator is getting bigger, and the denominator is getting smaller in the debt to GDP ratio?

Maurice Obstfeld:

Correct.

Michael Klein:

What happened after World War II? Because we had 106% of GDP, but then, we didn't have that into the '60s, right? Or, even through the '50s. How was it brought down?

Maurice Obstfeld:

Well, the fall in the debt GDP ratio between 1946 and 1956 is truly remarkable, it fell to about half it's level, and that was a result of a couple of things.

Maurice Obstfeld:

First of all, robust growth in the wake of the war. The US was doing quite well, have a lot of capital accumulation, output grew. There was also some inflation, though not excessive inflation, and interest rates were low. That was partially the result of financial regulations, and in the early part of that period, an explicit agreement between the Fed and the Treasury, which was later abolished to keep government borrowing rates low. So that was a remarkable development, and then the debt continued to fall relative to GDP, through the mid-1970s. By that point, it stood at a little bit more than 20% of GDP, which is hard to imagine or remember, but that is, indeed, where we were.

Michael Klein:

It's a little bit like thinking that we were wearing bellbottom jeans in 1979 as well, and hard to imagine that was something that we did then, too.

Maurice Obstfeld:

Another factor that I should mention, and this is related to the very recent performance of the debt up until this crisis, is that the Federal government was not running the big, primary deficits ... The primary deficit is the non-interest portion of the deficit, that we've come to live with in more recent years. So you had, basically, debt reduction going on all cylinders, and that hasn't been the case more recently.

Michael Klein:

Right. As you mentioned, the Tax Cut and Jobs Act increased the primary deficit just a few years ago, so we came into the crisis with a high primary deficit, relative to what we've seen in the past.

Maurice Obstfeld:

Yes.

Michael Klein:

How worried should we be? I mean, there are a lot of things to worry about now. Obviously, the COVID-19, the economy cratering, over the longer horizon, climate change, a lot of social issues around race. Where should we place the high government debt to GDP ratio in that list? Should it be at the top of the list, does it even make the list? What are your views on that?

Maurice Obstfeld:

Well, I think for the moment it doesn't make the list. The government has to do everything it can to support the economy, because to not do so would be very much penny wise and pound foolish. If you short circuit recovery at this point, by stinginess on the fiscal front, you will reduce the denominator in the debt GDP ratio much more than would be prudent. Of course, that brings with it a lot of pain and suffering.

Maurice Obstfeld:

So the government, at this point, should be going all out, and that will pay off dividends in the future. Just for an example, state and local governments are experiencing duress as their tax bases collapse and as their spending needs rise, and to avoid a large pro-cyclical fiscal contraction, Congress should provide more support to states and localities. So that's not something to worry about, at the moment.

Maurice Obstfeld:

After recovery is firmly established, we have to recognize that there could be some risks from higher debt to GDP ratios. But nonetheless, as long as the Fed can keep interest rates relatively low, especially compared to nominal GDP growth, we should be able to adjust that debt GDP ratio downward, without sharp fiscal measures.

Michael Klein:

So those are, to me, and I think to many others, very reasonable policy prescriptions. Maury, you've had policy experience at the very highest levels. Like I said in the introduction, you were in the Council of Economic Advisors, you were the chief economist at the IMF. What did you see when you worked in the policy world, that informs your views of how today's challenges may be addressed? Do politicians listen to economists?

Maurice Obstfeld:

Well, in the policy world, economics and politics are never that far apart. It's clear that, to some degree, policy decisions will be driven by political imperatives, rather than by some dispassionate notion of efficiency.

Maurice Obstfeld:

But, I think what differentiates good policy makers from bad is not the intrusion of politics, but the willingness to view the political outcomes through the lens of rigorous, and well-founded economic analysis, and well-founded facts, rather than a desire to make the world conform to one's preconceived ideas or preconceived notions. Policy makers have to be open to facts, to data, to fact based analysis.

Michael Klein:

Like what we have on Econofact, right?

Maurice Obstfeld:

Exactly.

Michael Klein:

Yeah. In fact, if the world won't conform to the way you want it to be, necessarily, that's I guess one of the lessons of economics, that there are these underlying forces that you really can't buck in the long run.

Maurice Obstfeld:

Exactly. Budget constraints are budget constraints, and your resources are your resources, and you have to work within those constraints.

Michael Klein:

So Maury, thank you very much for this very interesting, and very timely conversation. I really appreciate you participating in Econofact Chats, and also the memos that you've contributed to our site.

Maurice Obstfeld:

Thanks Michael, it's always a pleasure to talk with you, and to write for Econofact.

Michael Klein:

Well, it's great to have you both speaking with us today, and your memos being posted on our site. Thanks very much.

Maurice Obstfeld:

Okay, be safe, take care.

Michael Klein:

You too, you too.

Michael Klein:

Thanks for listening, this has been Econofact Chats. To learn more about Econofact, and see the work on our site, you can login to www.econofact.org. Econofact is a publication of the Fletcher School at Tufts University. Have a good day.