Multi-Trillion Dollar Fiscal and Monetary Gambles

By Eugene Steuerle *Thu, Sep 26, 2019*

'Right now, we're living with a $25 trillion wealth gamble by the Fed and trillion-dollar deficit bets by the Congress and the President,' writes our guest columnist.

Under pressure from President Trump and worried about a worldwide economic slowdown, the Federal Reserve recently cut short-term interest rates. By continuing to push rates down, the Fed may be doubling down on a $25 trillion gamble with future costs yet to be covered.

At the same time, the Trump Administration reportedly is considering tax cuts—that would add the deficit—to boost the economy in the short term. It too may be making another giant bet, with interest and debt repayments to be made by future taxpayers.

To understand why, keep in mind that what matters when government tries to spur economic growth is not the current rate of change in fiscal or monetary policy, but the change in the rate of change.

For instance, the short-term economy grows (all else equal) when the Fed accelerates the pace of growth in the money supply or when Congress increases Treasury's rate of borrowing by cutting taxes or increasing spending. Acceleration spurs growth, deceleration dampens it.

Suppose federal borrowing rises to 4% of national output. In a steady economy, merely keeping borrowing at 4% in future years adds no new stimulus. But raising the deficit to 5% of GDP, or more than $1 trillion today, would stimulate growth through a larger budget deficit relative to the size of the economy.

To keep the wheel spinning, Congress needs to borrow ever-greater amounts—increasing the rate of change in debt accumulation. In an actual downturn, that additional borrowing would be on top of the old rate of borrowing plus the new borrowing forced by the decline in revenues—which is why many economists fear that each new fiscal gamble in good times increasingly deters future fiscal responses to a recession.

The same goes for monetary policy. Though not the only factor involved, the extraordinarily low short-term interest rates the Fed has maintained over recent years has helped promote an increase in the rate of wealth accumulation. The measured wealth of households rose from a long-term average of less than 4 times GDP to well over 5 times GDP. While that ratio fell closer to its historical level in the Great Recession, it has since risen to an all-time high. That's about a $25 trillion increase that, if history is a guide, could become a $25 trillion loss if the ratio of wealth relative to income merely reverts to its average.

All those additional budget deficits and increases in household wealth, in turn, spur consumption. For instance, a recent NBER working paper by Gabriel Chodorow-Reich, Plament T. Nenov, and Alp Simsek suggests that a $1 increase in corporate stock wealth increases annual consumer spending by 2.8 cents. Building on that estimate, conservatively suppose each dollar increase in all types of wealth boosts annual consumption by about 2 cents. That would mean that a $25 trillion wealth bubble would spur this year's consumption by about $500 billion, or about 2.5%age points of GDP more than had wealth simply grown with income.

What do you do if you're Congress and an economy operating at full employment starts to slow down a bit? To spur the economy, you need to increase budget deficits at an even faster rate than before. If you're the Fed thinking about sustaining or increasing consumption based on the wealth effect, then you try to maintain or increase the wealth bubble by not allowing housing or stock prices to fall.

How does this end? Science tells us: Not well. For instance, imagine an insect species identifies a new food source. The insect population will multiply rapidly until the demand from its accelerating birth rate outstrips the supply of food and the insect population crashes.

The economist Herb Stein described this phenomenon as simply and clearly as possible: "If something cannot go on forever it will stop."

Our fiscal situation may not be that dramatic, but large budget deficits can lead to economic stress, and eventually, a crash. That has been the fear historically, though the recent experience of easy money across the globe, very low interest rates, and associated wealth bubbles may have offered a reprieve of sorts. However, interest rates that turn negative on an after-inflation, after-tax basis can lead to unproductive investments, which, in turn, can slow real economic growth even without a crash.

The modern economy may protect us in some ways. For example, the flow of international trade may mitigate economic slowdowns in any one region. And a service economy may not face some of the tougher business cycles that threaten an industrial one. But none of these factors overcomes Stein's Law: Fiscal and monetary policy cannot always operate on an accelerating basis. To maintain the flexibility to accelerate sometimes, they must decelerate at other times.

Right now, we're living with a $25 trillion wealth gamble by the Fed and trillion-dollar deficit bets by the Congress and the President. We've yet to see how it all ends and how the bills will be paid. How safe do you feel that your winnings will cover your share of those bills?