

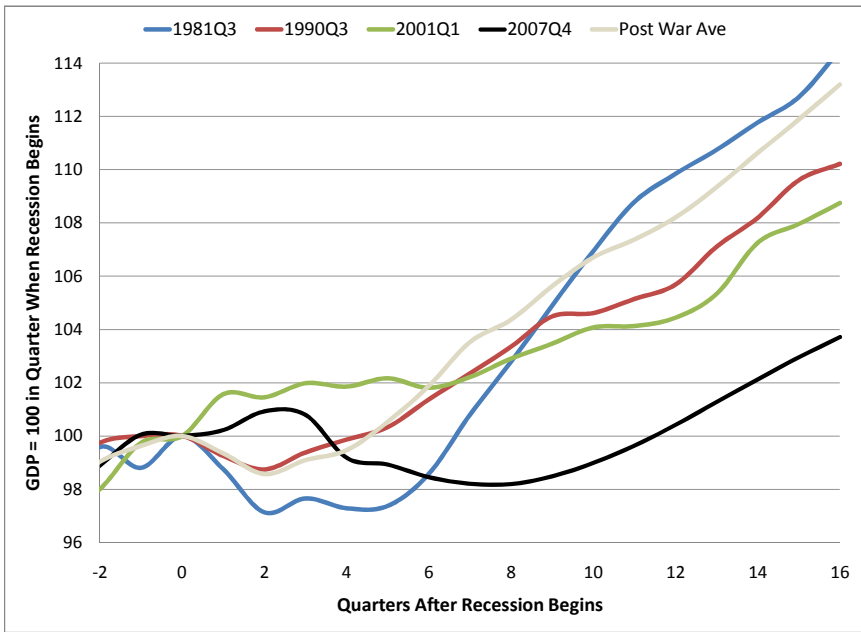
FINANCIAL MARKET TURMOIL AND
RECESSION: WHAT'S NEXT?
THE FISCAL POLICY RESPONSE

Eric M. Leeper

Department of Economics, Indiana University

©2009 by Eric M. Leeper. This document may be reproduced for educational and research purposes, so long as the copies contain this notice and are retained for personal use or distributed free.

THIS RECESSION VS. PAST RECESSIONS



PROXIMATE CAUSE OF RECESSION

- Declines in house prices & stock market reduced household wealth
- Inability of households & firms to get credit
- Sharply reduced demand for goods & services
- With no turnaround in sight, expect demand to be weak indefinitely
- Firms cut back on investment & lay off workers

STIMULATING DEMAND

- Demand for goods & services is due to
 - households: consumption
 - firms: investment
 - government: purchases of goods & labor
 - foreign sector: purchases of U.S. goods
- Monetary policy (the Federal Reserve): reduces interest rates
 - raises consumption & investment
- Fiscal policy (Congress & President): increases government spending & reduce taxes
 - raises consumption, investment, & government purchases

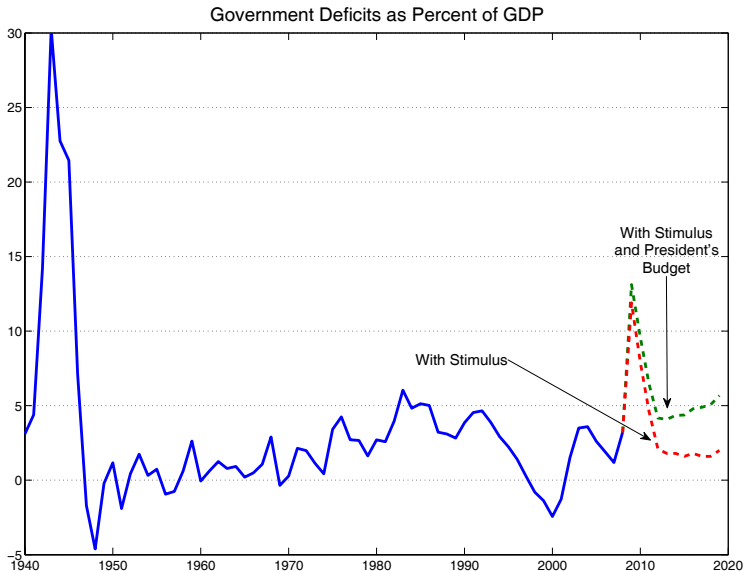
THE STIMULUS PACKAGE

	2009	2010	2011	2012	2013	2014	2009 -2019
Budget							
Authorization	379.0	114.7	53.6	11.2	9.8	16.2	580.7
Outlays	120.1	219.3	126.2	46.2	30.3	27.9	575.3
Revenues	-64.8	-180.1	-8.2	10	2.7	5.5	-211.8
Net Increase in Deficit	184.9	399.4	134.4	36.1	27.6	22.4	787.2

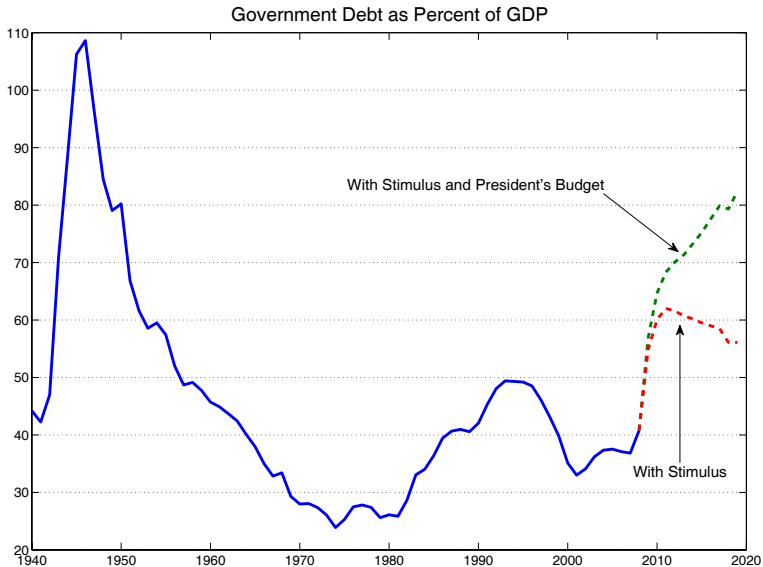
Billions of Dollars

A mix of tax cuts, infrastructure spending, transfer payments, and the other white meat

AN UNPRECEDENTED FISCAL RESPONSE



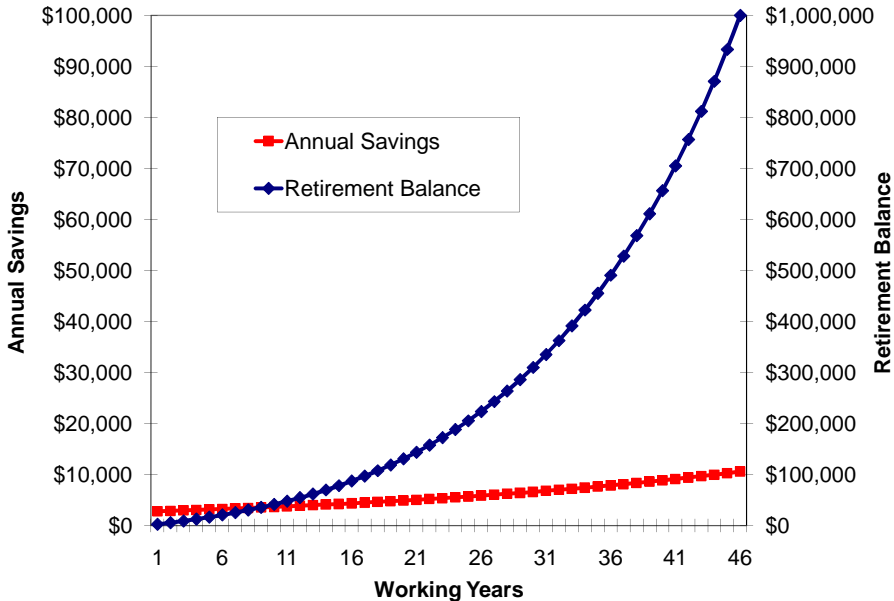
AN UNPRECEDENTED FISCAL RESPONSE



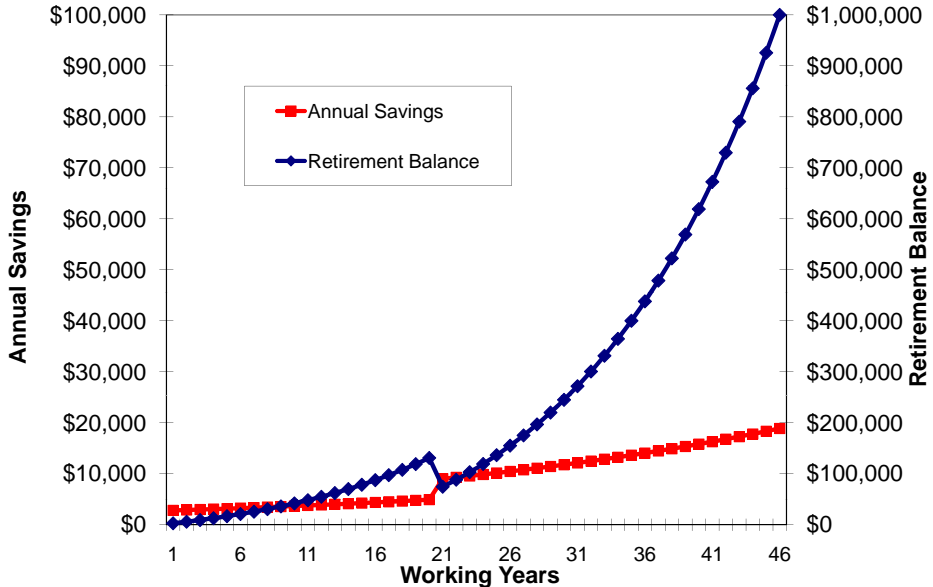
WHAT IS THE STIMULUS TRYING TO DO?

- Demand—largely through consumption—took a big hit
- Normally people try to “smooth” consumption by saving *less* when income falls temporarily
- But we’ve seen a sharp increase in savings
 - from 0% to 5% of income
 - due to large decline in wealth
- Why?
- To prepare for retirement, people target their wealth
 - when their wealth falls, they have to save more to achieve their target

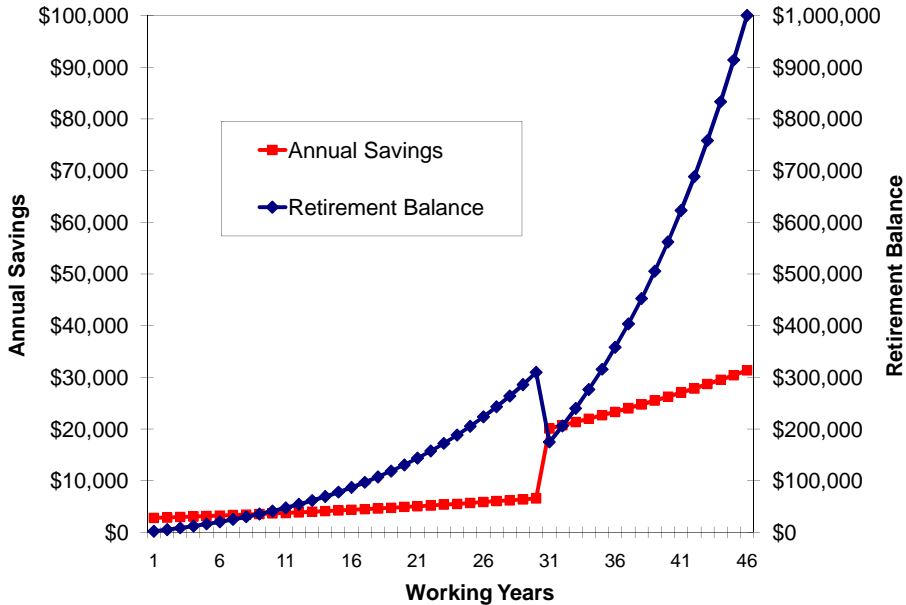
HITTING A WEALTH TARGET



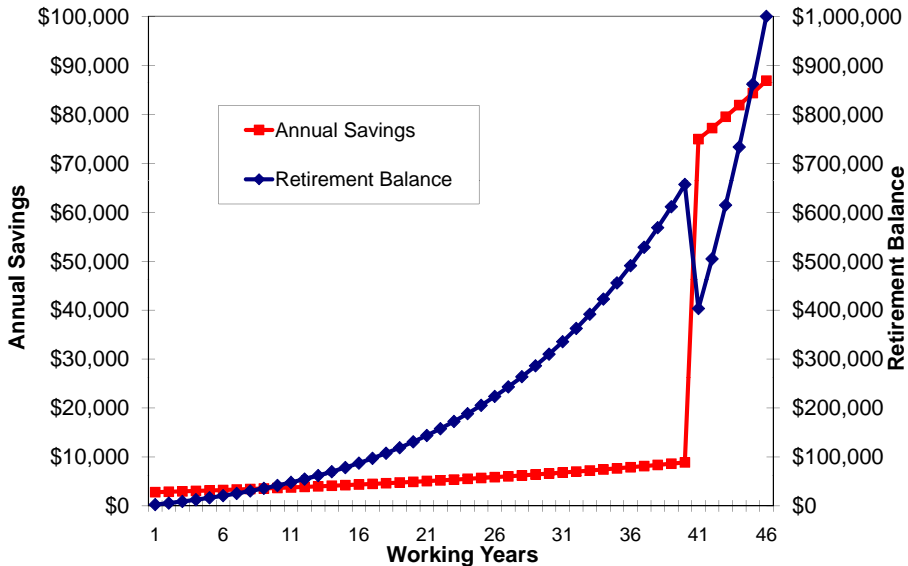
HITTING A WEALTH TARGET



HITTING A WEALTH TARGET



HITTING A WEALTH TARGET



WHAT IS THE STIMULUS TRYING TO DO?

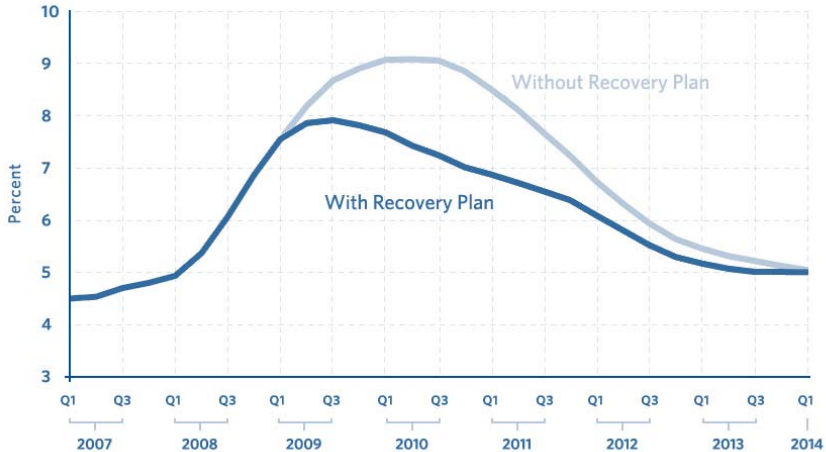
- It is rational for individuals to increase their savings
- “Paradox of thrift”: what’s good for individuals may be bad for the overall economy
- Consumption is 70% of U.S. GDP
- U.S. firms & workers geared up to produce consumption goods
- Government spending increases & tax cuts can have “multiplier” effects on private consumption

LIKELY EFFECTS OF THE STIMULUS

- Begin with the government's claims
- Turn to some theoretical predictions from formal economic models

PREDICTED EFFECTS OF STIMULUS: I

Figure 1
Unemployment Rate With and Without the Recovery Plan



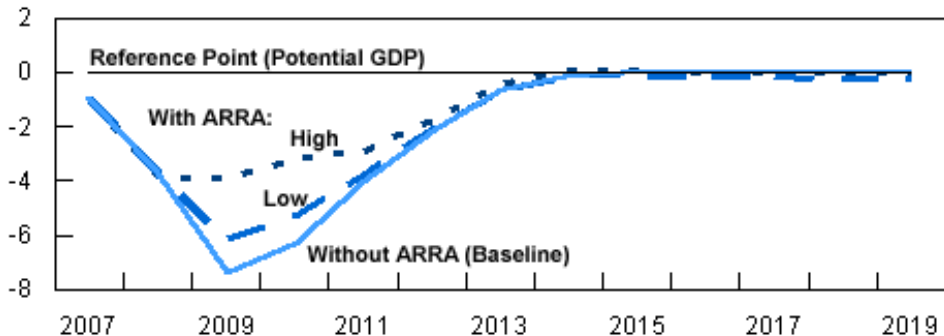
Source: Romer-Bernstein (2009)

PREDICTED EFFECTS OF STIMULUS: II

Job Creation of Recovery Package by Industry	
Industry	Job Created in 2010Q4
Mining	26,000
Construction	678,000
Manufacturing—Total	408,000
Wholesale Trade	158,000
Retail Trade	604,000
Information	50,000
Financial Activities	214,000
Professional and Business Services	345,000
Education and Health Services	240,000
Leisure and Hospitality	499,000
Other Services	99,000
Utilities	11,000
Transportation and Warehousing	98,000
Government—Total	244,000
Total	3,675,000

Source: Romer-Bernstein and Mark Zandi, Moody's economy.com

PREDICTED EFFECTS OF STIMULUS: III

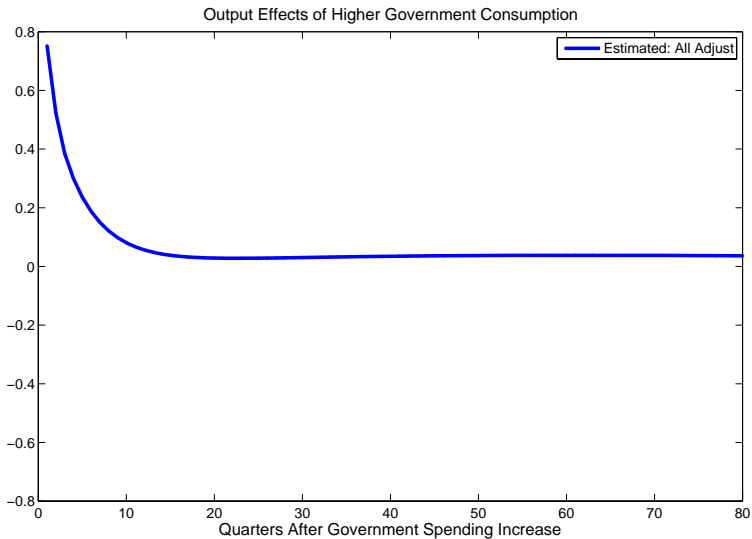


Source: Congressional Budget Office (2009)

FISCAL FINANCING

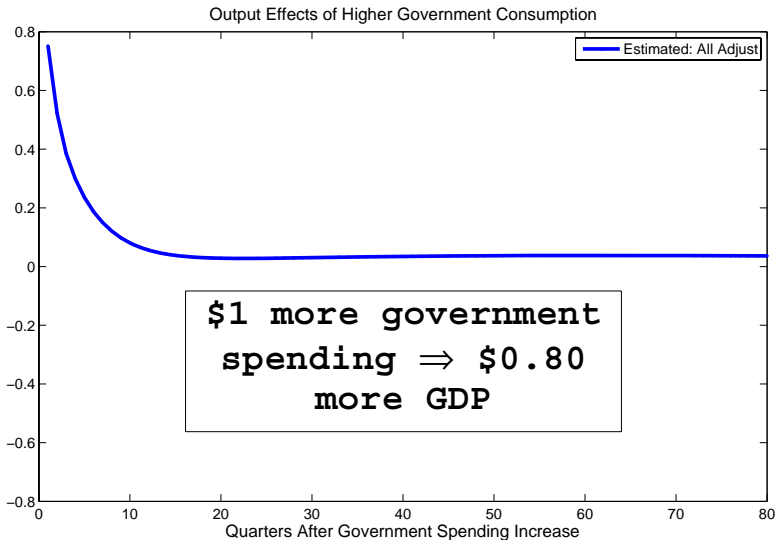
- Fiscal stimulus will initially be financed by borrowing
- This raises government indebtedness
- Requires *some* adjustment in policies in the future to finance the debt
 - raise various taxes
 - reduce total spending
- How will alternative *future* financing choices modify the impacts of higher *current* government spending?
- Address this in an estimated economic model

FISCAL FINANCE: HISTORY



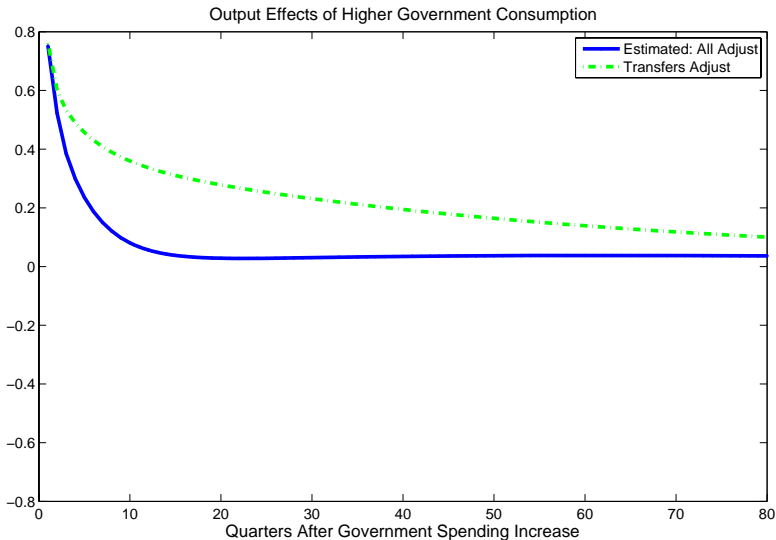
Source: Leeper, Plante, Traum (2009)

FISCAL FINANCE: HISTORY



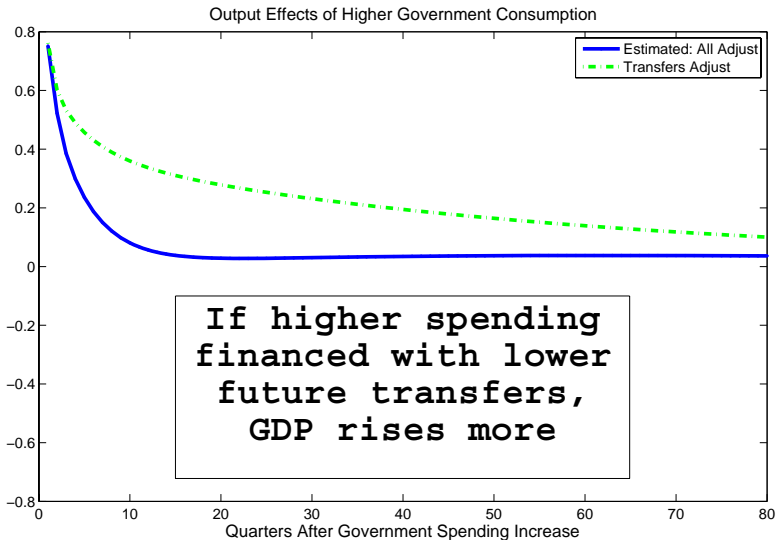
Source: Leeper, Plante, Traum (2009)

FISCAL FINANCE: TRANSFERS ADJUST



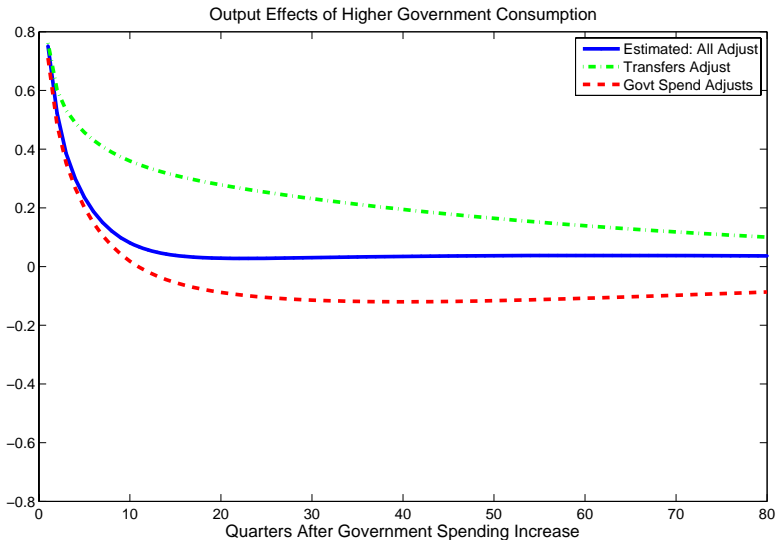
Source: Leeper, Plante, Traum (2009)

FISCAL FINANCE: TRANSFERS ADJUST



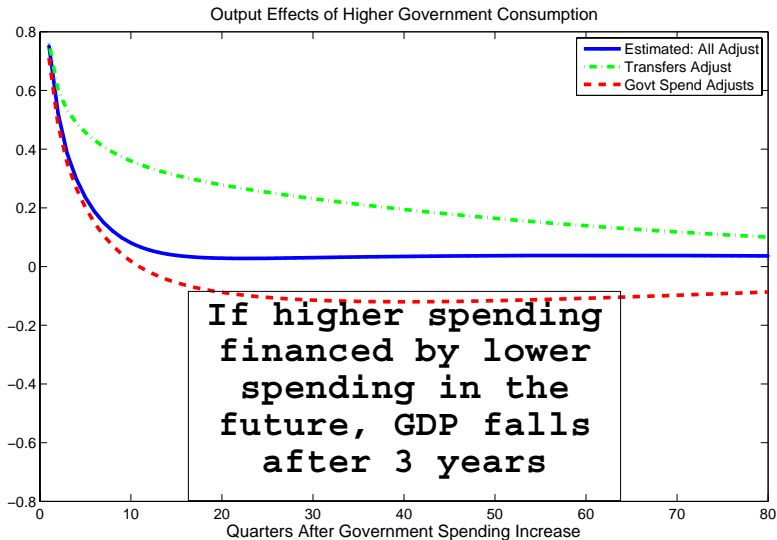
Source: Leeper, Plante, Traum (2009)

FISCAL FINANCE: GOVT. SPENDING ADJUSTS



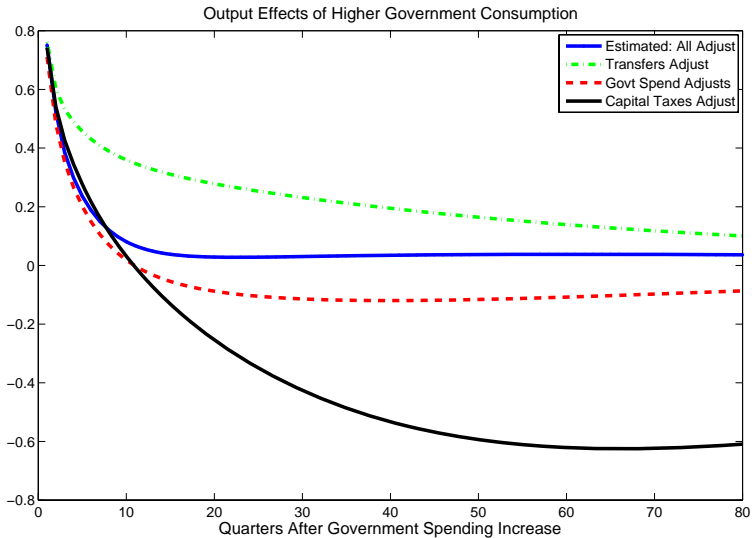
Source: Leeper, Plante, Traum (2009)

FISCAL FINANCE: GOVT. SPENDING ADJUSTS



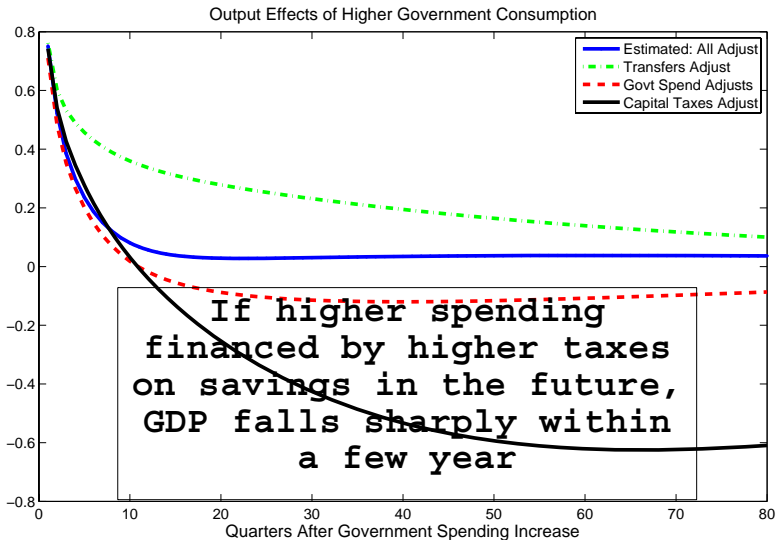
Source: Leeper, Plante, Traum (2009)

FISCAL FINANCE: CAPITAL TAXES ADJUST



Source: Leeper, Plante, Traum (2009)

FISCAL FINANCE: CAPITAL TAXES ADJUST

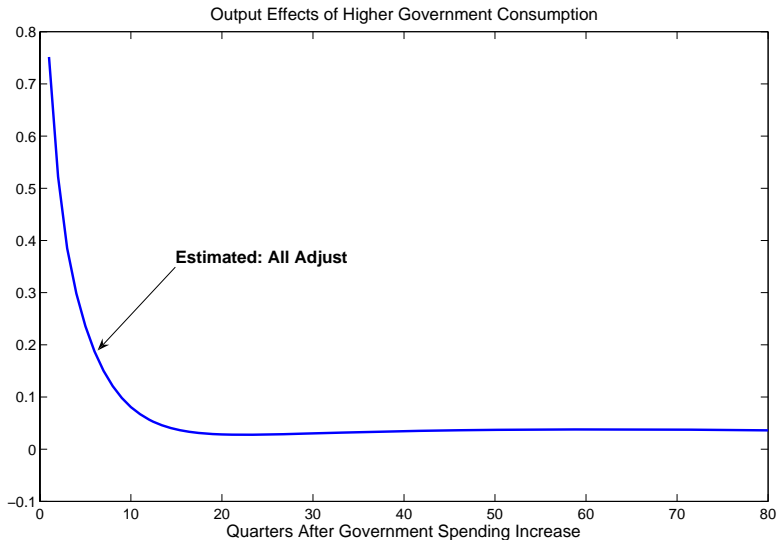


Source: Leeper, Plante, Traum (2009)

SHOULD WE WORRY ABOUT THE DEFICITS?

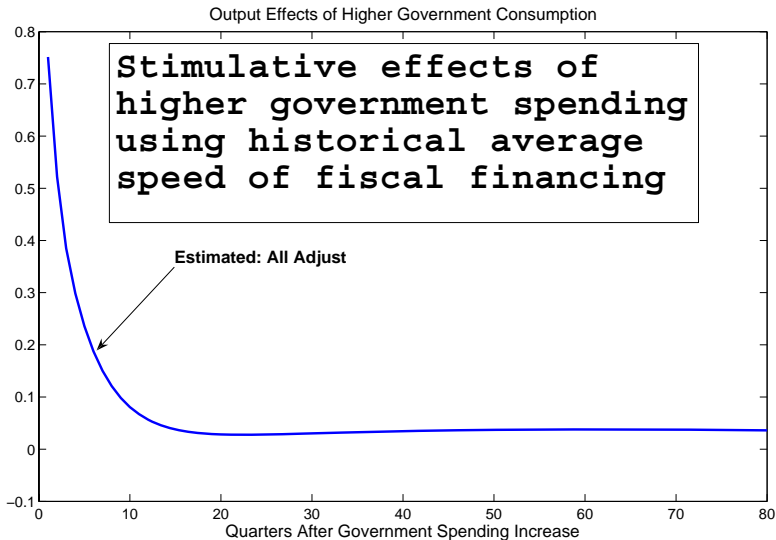
- Recently Obama has called for “fiscal responsibility”
- Pledged to cut the fiscal deficit in half by 2012
- This will be accomplished by cutting government spending & raising taxes on families earning \$250K or more
- What are the consequences of this for the current fiscal stimulus?
 - will this enhance or retard the stimulus?
- Use the same estimated model to show consequences

FUTURE FISCAL ADJUSTMENT: HISTORICAL



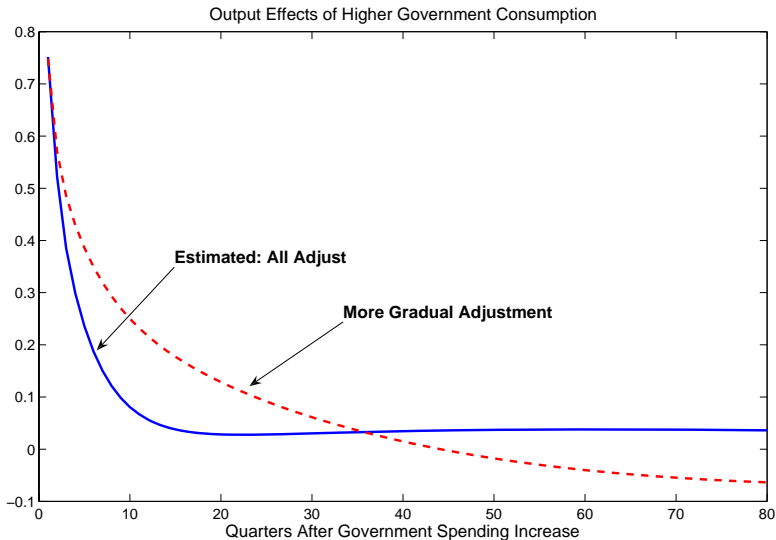
Source: Leeper, Plante, Traum (2009)

FUTURE FISCAL ADJUSTMENT: HISTORICAL



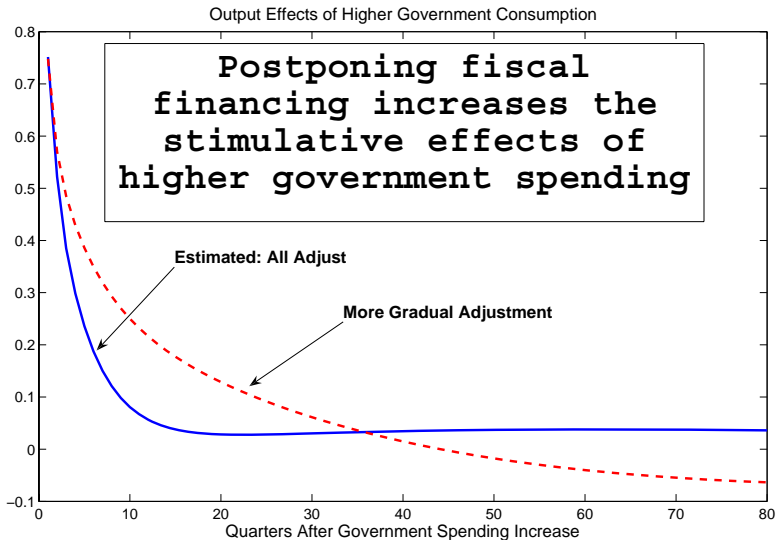
Source: Leeper, Plante, Traum (2009)

FUTURE FISCAL ADJUSTMENT: GRADUAL



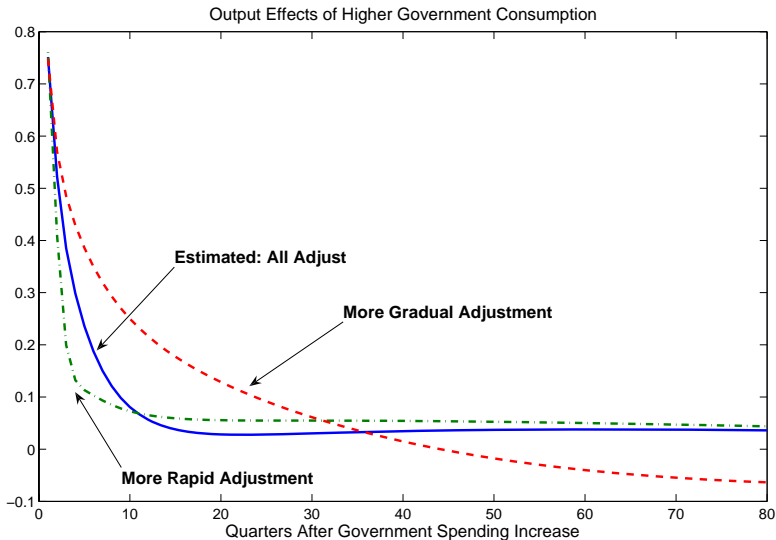
Source: Leeper, Plante, Traum (2009)

FUTURE FISCAL ADJUSTMENT: GRADUAL



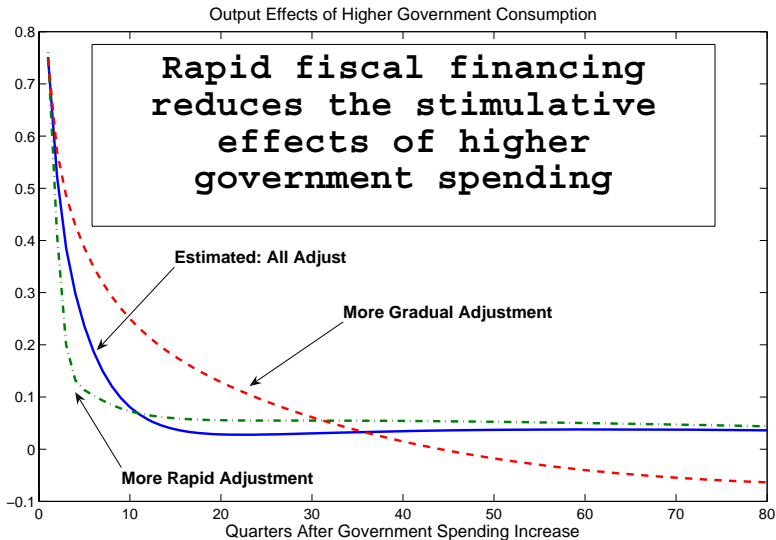
Source: Leeper, Plante, Traum (2009)

FUTURE FISCAL ADJUSTMENT: OBAMA PLAN



Source: Leeper, Plante, Traum (2009)

FUTURE FISCAL ADJUSTMENT: OBAMA PLAN



Source: Leeper, Plante, Traum (2009)

FISCAL STIMULUS SUMMARY

- Fiscal stimulus is the right policy to combat weak demand
- Impacts depend on how people expect deficits will be financed—need transparency about fiscal policy
- Stimulus less effective the more rapidly deficits are retired—counterproductive to fret about high government debt
- Most importantly: stimulus will not be fully effective until financial market & banks are healthy—getting the financial system working is Job #1