

The “Fiscal Cliff” Scenario

At some point, the federal stimulus checks will stop coming. Consumer sentiment could continue to be affected by fear of further Covid-related complications. The world economy hardly looks trouble-free. Is it possible that U.S. policymakers fired all their fiscal stimulus cannons too soon? Will they be short of ammunition in the event the economy in 2022 significantly underperforms? Some economists, using a different metaphor, describe the danger as “running head-on into a fiscal cliff.” To what degree should U.S. policymakers be concerned? The economy was already rebounding. Should policymakers have held back on sending out the checks until 2022?

Twenty noted observers rate the risks.

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The real dilemma is not the fiscal cliff of 2022, but the downshift in the real growth trajectory.

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Medical researchers largely group Covid-19 patients in three categories: asymptomatic, regular Covid, or long haulers. If we bring this trio of classifications to the economic realm, it is clear that no country’s economy could be considered asymptomatic. Around the globe, fiscal and monetary authorities treated their economies as though they had regular Covid: shock therapies of monetary easing, massive and often repeated fiscal transfers, and corporate bailouts. Now, for the United States, we must examine whether having survived the early economic cytokine storm, a continued malaise similar to long Covid will set in. Also important is whether the policy doctors have new treatments in their tool kit to treat this ailment or whether we must just wait for it to run its course.

As with so many parts of our daily lives and professions, Covid has challenged foundational assumptions, adding new variables to longstanding patterns. The nature of the virus and associated shutdowns have led to production shortages and bottlenecks across the global supply chain. In addition, work from home and Covid anxiety have caused workers to retreat or retire from the workforce, resulting in employee shortages. Finally, long-dormant price pressures have emerged at an inconvenient time to squeeze real wages and dampen animal spirits.

Overall, the U.S. economy has learned to live with the virus. Mobility data shows that the Delta variant has not caused a retreat from the already undertaken reopening patterns, but it has likely slowed the pace of the reopening, inventory restocking, and service sector hiring. What looked like a potentially runaway economy in the second half of 2021 will now certainly see a deceleration toward the end of 2021 and into 2022 as the surety of government transfers is replaced by an improving but tentative private sector recovery. Even as an increased prevalence of antibodies in the U.S. population controls outbreaks, shortages will continue to inhibit economic

growth. This is the first time in thirty years that I have observed supply constraints, rather than demand declines, causing PMIs to retreat.

For 2022, it is unlikely that the United States will hit an economic air pocket that takes the economy into recession. Rather, the balance of probabilities favor an uncomfortable mix of sticky inflation and below trend growth. Policymakers, having rescued the patient using shock therapy in the acute phase, will have limited room for maneuvering.

Increased levels of government spending and the commensurate additional debt are polling poorly with American voters, especially independents. Next year—2022—is a mid-term election year, making it unappetizing for swing-district members of Congress to layer on the already massive but drawn-out spending packages slated to pass during the remainder of 2021. The Federal Reserve, having signaled that it will begin to taper quantitative easing in the coming quarters, is unlikely to reverse, or even pause, barring a serious economic downturn.

The real dilemma is not the fiscal cliff of 2022, but the downshift in the real growth trajectory of the United States in the post-Covid years.

The views presented in this article are purely the opinions of the author and are not intended to constitute investment, tax, or legal advice of any nature and should not be relied on for any purpose.



We are far from any fiscal cliff.

JOSEPH E. GAGNON

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The Covid-19 pandemic prompted the fastest increase in U.S. federal spending since World War II. The budget deficit soared to 15 percent of GDP in 2020 and remains in double digits this year. No set of policies could have prevented a sharp recession last year, as consumers and workers sheltered at home while businesses adapted to massive shifts in spending patterns. But most households received federal aid that fully compensated

them for lost labor income, helping to prevent a cascading drop in overall demand and enabling the most rapid economic turnaround ever recorded.

The fiscal deficit is projected to shrink rapidly next year, even if Congress passes the large physical and social infrastructure bills currently being negotiated. Some may worry that the drop in federal spending will tank economic activity. However, the large bulge in household savings carried over from last year, booming house and stock prices, the strong condition of state and local government finances, and easy monetary policy should support continued economic growth.

The biggest risk arises from Covid-19. The current Delta wave of infections has had less of an economic impact than previous waves. If the Delta wave declines in the autumn, as many experts are predicting (as of August 2021), pent-up demand should continue to support a strong recovery and employment should return to, or beyond, its pre-pandemic peak next year.

On the other hand, if delays in booster shots or a new variant causes the pandemic to take a turn for the worse, private spending might not fill the fiscal gap. In that case, a new round of income support would be needed.

With federal debt having risen from 80 percent to 100 percent of GDP in just two years, are there grounds to worry about the U.S. government's ability to finance further income support? Absolutely not. The record low level of interest rates on federal debt amply demonstrates that financial markets are begging the government to borrow more. Japan shows that even larger debt ratios can be supported indefinitely.

Could interest rates jump unexpectedly and cause problems for future administrations? The most comprehensive studies suggest that demographics will keep the equilibrium real interest rate low for years to come. Moreover, the main likely cause of any surprise future rise in real rates—higher productivity growth—would be welcome news that would simultaneously boost tax revenues to service debt. Another possible driver of higher interest rates—surging inflation—would be at most a temporary phenomenon that the Fed knows how to control. We are far from any fiscal cliff.



The so-called stimulus payments were saved and did not stimulate.

JOHN B. TAYLOR

George P. Shultz Senior Fellow in Economics, Hoover Institution, Mary and Robert Raymond Professor of Economics, Stanford University, and former Treasury Under Secretary for International Affairs

We have seen government deficits bulging to over 13 percent of GDP, federal debt skyrocketing to over 100 percent of GDP, and the Federal Reserve purchasing gigantic amounts—\$120 billion per month—of Treasury securities and mortgages. And economic growth is rapid as we have emerged from the pandemic-driven recession of 2020. The high growth and big deficits have led many to believe that there is simply no reason to worry about deficits. The federal government can just keep spending and bond buying with no danger of running out of ammunition should there be another pandemic or reason for a recession.

But basic economics and real-world lessons suggest otherwise. Between March 2020 and March 2021, the United States enacted three fiscal packages which raised the deficit with the hope of stimulating the economy. President Trump signed one package into law on March 27, 2020, and another on December 27, 2020. President Biden signed a third on March 11, 2021.

Each piece of legislation paid funds to people with the hope that they would spend the increased income and stimulate the economy. The rationale was Keynesian: that any increase in income boosts the economy. But alternative proven views, such as Milton Friedman's permanent income hypothesis, say that such temporary increases in income do not stimulate the economy.

In fact, data and economic models show that the so-called stimulus payments in the legislative packages were saved and did not stimulate, just as the permanent income model predicted. Instead, the economy recovered as Covid-19 vaccines were discovered and applied, and private businesses started opening again and hiring people. A challenge now is to reverse these deficit-increasing actions and commit to a sound fiscal policy in the near future. This is needed for a strong recovery driven by the private sector. If an agreement could also be made to lower

the growth rate of government spending and to keep tax rates from rising, then the policy will be more powerful. And the United States would be in better shape should a recession emerge again.

Government spending should be aimed at helping people directly affected by the pandemic and at particular problems in the economy, including needed infrastructure projects. A fiscal consolidation policy—rather than gigantic deficits—will lead to stronger growth. And if there is another economic downturn, we will have both a stronger economy and a deficit under control. We would therefore have the wherewithal to combat any recession by a predictable counter-cyclical tax reduction and spending increase, letting the deficit grow in a predictable way for a shorter period. That is the kind of ammunition we need now in the U.S. economy.



The notion that debt hovering at 100 percent of GDP now imposes limits on fiscal rescue is tough to defend.

ROBERT J. BARBERA

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No one can deny the dramatic expansion of U.S. federal deficits and debt. But the notion that debt hovering at 100 percent of GDP now imposes limits on fiscal rescue is tough to defend. There are examples of debt crises—think Argentina, Greece, Thailand. But the next wealthy nation that borrows in a currency it can print and has a sovereign debt crisis will be the first.

Debt crisis stories are easy to tell when a government's real borrowing rate exceeds its economy's real growth rate. But that's not the case for the United States and for other wealthy nations. Indeed, history offers us a long list of sovereign debt crises that didn't happen, despite countries carrying debt-to-GDP ratios well in excess of today's U.S. level. Sadly, if the U.S. economy were to swoon, misguided or ill-motivated elected officials might choose to invoke debt-bomb worries and deep-six stimulus efforts. But current U.S. fiscal circumstances pose no impediment to delivering another large dose of fiscal stimulus.

Critically, for the past seventy years, the U.S. government, on average, paid a real interest rate well below its real growth rate. Real GDP rose at a 3.3 percent pace and real borrowing costs averaged 1.8 percent, thus the U.S. real borrowing rate was 1.6 percentage points less than its real growth rate. When such fantastically cheap finance is available, high levels of debt are easy to roll over.

How high? Over the ten years ending in 2019, Japan's real borrowing costs were modestly lower than the economy's real growth rate, notwithstanding the fact that Japan's debt was growing from 200 percent to 240 percent of GDP. As Japan's debt rose to 266 percent of GDP during the pandemic, the bond market vigilantes punished Japan with ten-year borrowing rates of 2 basis points.

But Japan is a model of political stability. In light of January 6, perhaps Italy is a more relevant comparison. Amid the 2020 pandemic as Italy's debt rose from 135 percent to 156 percent of GDP, its borrowing rate fell from 2.5 percent to 1 percent, despite the fact that Italy only partially controls its own currency.

Swoon worries aside, policymakers may face other daunting near-term issues relating to fiscal and monetary stimulus. Conventional economists warn that stimulus may collide with capacity constraints and reignite inflation. Economists focused on finance, including this one, worry about asset market excesses. These concerns, however, do not link to prospective debt issuance limits. Successfully managing such traditional business cycle challenges, should they arise, will be taxing. They would not, however, call for an independently motivated commitment to "rein in debt issuance."

Thus, the arithmetic of government finance strongly suggests no debt bomb looms. But voluminous data— not to mention fires, floods, sea levels, and collapsing glaciers—led the United Nations' Intergovernmental Panel on Climate Change to declare that climate change is not just coming. It is here. Large-scale government-funded efforts to stem rising temperatures make extraordinary sense. At the moment, ample labor and capacity excesses allow for the harnessing of idle resources to fight climate change. If, prospectively, we can only accommodate expanded commitments to green efforts with slower growth elsewhere, fiscal commitment to climate change mitigation can be continued alongside monetary policy restraint and tighter financial conditions. Yes, dramatically ramping up the environmental defense budget may redeploy resources to defuse the time bomb of climate change. That's what successful nations do when facing an existential threat.



The past 18 months of massive stimulus have not used up the ammunition needed to head off another Covid-based downturn.

ROBERT SHAPIRO

Chairman, Sonecon, and former U.S. Under Secretary of Commerce for Economic Affairs

The U.S. economy is not at significant risk from government running out of ways to support it if consumer spending weakens. The prospect that consumers will pull back if the pandemic continues to worsen, and so push unemployment up again, is real. As I write this, however, the administration and Congress are preparing large-scale supply-side stimulus through the infrastructure and reconciliation legislation. If the pandemic worsens sufficiently this autumn and winter to warrant another round of partial lockdowns, the administration and Congress could—and likely would—support consumer spending and the economy through another round of checks for most households and an extension of enhanced unemployment benefits.

The political economy of this pandemic now seems clear. In normal times, consumer spending roughly tracks wage and salary income. For example, both rose steadily from July 2019 to February 2020, the eight months preceding the pandemic. Covid-19 affected that normal relationship by driving up saving rates. Consumer spending fell much more sharply than wage and salary income in March and April of 2020, because the personal saving rate jumped from 8.3 percent in February to 33.8 percent in April, draining people’s resources for spending. The government stepped in with the first of three rounds of checks for most households and large expansion of unemployment benefits, and those waves of free money allowed people to resume spending even while saving 24.8 percent of their disposable incomes in May and 19.3 percent in June.

Employment recovered substantially over the second half of 2020, thanks largely to government stimulus; and consumer spending once again grew steadily with rising wage and salary income. When the third wave of the pandemic weakened consumer spending again in late 2020, Congress issued a second round of checks to households in December and a third and larger round along with additional stimulus in late January. With those supports, and with wage and salary income continuing to rise, consumer spending, employment, and GDP have boomed.

If the fourth wave of the pandemic proves serious enough to cut sharply into people’s recreational spending and travel plans, the stimulus from the pending infrastructure and reconciliation bills should keep wage and salary income rising, and consumer spending with it. Based on Treasury yields, the capital markets do not expect those measures to ignite structural inflation that would slow the economy by driving up interest rates. If the outlook turns dire enough to require school closings and business lockdowns, and the personal saving rate soars again, a fourth round of checks and other short-term stimulus could once again support consumer spending and growth. The flood of new personal saving should also help the Fed maintain low interest rates in the face of the additional stimulus, as it did in 2020.

The past eighteen months of massive stimulus have not used up the ammunition needed to head off another Covid-based downturn. Rather, the lesson is that repeated large-scale intervention in an economy distorted by a terrible pandemic works reasonably well.



Fiscal space currently remains to counter a new recessionary shock.

WILLIAM R. CLINE

President, Economics International Inc., and Senior Fellow Emeritus, Peterson Institute for International Economics

Relief spending and revenue loss from the Covid-19 shock has boosted U.S. federal debt held by the public from 79 percent of GDP in 2019 to 102 percent, and the Congressional Budget Office projects it will reach 106 percent by 2031. A prudential real interest rate for fiscal planning should arguably be set at no less than 1 percent, the 33rd percentile of the past six decades. At this interest rate, the traditional “Maastricht” debt limit of 60 percent of GDP would translate to 130 percent. The corresponding translation for the 3 percent of GDP Maastricht target for the fiscal deficit would be to 4.2 percent. The Congressional Budget Office projects average fiscal deficits at 4.1 percent for 2022–2031, leaving little if any remaining space on this metric. Deficit targets are meant to be met on average, but the permanent nature of social spending constrains the scope for a swing to low deficits

(let alone surpluses as in 1999–2001) during good years to compensate for stimulus during bad ones. Even so, fiscal space currently remains to counter a new recessionary shock of plausible size in the near term.

Concern about fiscal space seems more warranted for the medium and longer term, however. The Build Back Better legislative initiative, comprising an infrastructure American Jobs Plan and a social American Families Plan, could exhaust much of the remaining fiscal space. The Office of Management and Budget projects that the administration’s program would boost primary (non-interest) spending by \$4.8 trillion over 2022–2031. Higher revenue would amount to \$3.6 trillion, with corporate taxes providing almost two-thirds of the increase. Average deficits would rise to 5.2 percent of GDP. The budget optimistically assumes the real ten-year interest rate is an average of only 0.25 percent over the coming decade, and counts on some \$700 billion from improved tax enforcement. The OMB projections show debt held by the public rising to 117 percent of GDP by 2031. The Committee for a Responsible Federal Budget estimates the ratio could reach 129 percent by then if the 2017 tax cuts are made permanent rather than being allowed to expire in 2025, and if real discretionary spending is allowed to grow with the economy.

The bottom line is that however worthy the goals of Build Back Better, the plan could benefit from expenditure prioritization that slims down the target increase in primary spending (currently planned to rise from baseline by an average of 2 percent of GDP over the decade), and/or from larger coverage by revenue measures, to avoid risking undue erosion of medium- and long-term U.S. fiscal space.



It is a risk, but one that may not be as urgent as that of missing a policy pivot.

MOHAMED A. EL-ERIAN
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and Chief Economic Adviser, Allianz*

It is a risk, but one that may not be as urgent as that of missing a policy pivot that’s critical for anchoring high and durable growth, moderate inflation, and manageable financial volatility.

The U.S. economy is in urgent need of a recalibration of its policy mix involving three aspects. First is a continued evolution of fiscal policy, away from a heavy emphasis on relief measures to one involving longer-term pro-growth measures, including bold investments in physical and human infrastructure.

Second is an easing of the “pedal-to-the-metal” monetary policy through the early initiation of a gradual tapering of the Federal Reserve’s large-scale asset purchases (“QE”).

And third is a greater emphasis on financial prudential measures, especially those pertaining to non-bank intermediaries.

Absent a timely pivot, the U.S. economy could face more than a rising risk of undue damage to the much-needed economic recovery. It could also face the threat of unsettling financial market instability and high inflation.

In addition to making the economic recovery less durable and undermining efforts to counter the inequality trifecta (of income, wealth and opportunities), this would threaten the implementation of President Biden’s transformational economic agenda aimed at enhancing America’s potential for high, inclusive, and sustainable prosperity.

Fortunately, these risks can—indeed should—be minimized. But the window for doing so can close rapidly, especially in a global economy experiencing the threat of additional Covid disruptions on account of incomplete vaccinations, rising infections, and new variants of the virus.



We have become relaxed about the long-term certainty of public debt over 100 percent of GDP. But we are also steadily increasing the tail risks.

W. BOWMAN CUTTER
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The macro data is admittedly uncertain and our actual macro course in the future is even more so. But my expectations are as follows:

First, inflation will increase over the next year. It may touch 3 percent or more briefly, but it will not spiral out

of control. In fact, it may be that the effects of the rapid spread of the Delta variant of the Covid virus will lower inflation risks and cause the Fed to slow down any taper.

Next, for the remainder of this year, U.S. growth will be high but below the forecasts of the spring. Over the next three years, growth will move steadily down to its pre-epidemic trend of below 2 percent. I've seen no convincing arguments that productivity has meaningfully increased.

And finally, U.S. rates will remain quite low. Of course they will bounce around. But rates have been on a multi-decade decline and that may slow down but won't reverse.

Put together, these factors suggest an economy that gives policymakers continuing fiscal space (the slope) but also implies steadily increasing risk (the upward slope) as that room is used. We have become accustomed and (sort of) relaxed about the long-term certainty of public debt well over 100 percent of GDP. But as that percentage goes relentlessly higher, I have to believe that we are also steadily increasing the tail risks we are exposed to.

For policy, this implies, first, that there probably is ample room for substantially increased public investment. For example, the Biden infrastructure plan of \$3.5 trillion over ten years (which is very unlikely to be the end result) amounts to spending of 1 percent to 2 percent of GDP per year. Whatever you may think of the merits of the actual spending, we can easily afford that amount of additional spending.

Second, there is not ample room for a major sustained increase in annual spending. All of the pressures forcing up public spending that were apparent pre-epidemic are still there. Spending will inexorably rise, and there is no obvious appetite for raising revenues. And we have to be mindful of history—twice in the last fourteen years we have been forced to enact major stimulus programs. It is not impossible that need will come around again.

Third, the Fed should stay where it is and not make any substantial moves. One exception: Larry Summers' argument that we should take advantage of exceptionally low long-term rates and lengthen the term structure of debt should be taken seriously.

And last, budgets should matter again. There has not been a "normal" budget process in the last twenty years.

But these modest suggestions, and the almost certainly much wiser comments that will be made by others in these pages, are probably pointless. The dysfunction of our politics and the disintegration of our policy processes make any expectation of a rational policy debate over the next three years laughable.



The unprecedented higher deficits and debt will come back to haunt America in unacceptably high inflation.

ALLEN SINAI
Chief Economist and President, Decision Economics, Inc.

Election 2020 signaled a huge shift in Washington policy—a Biden “New” New Deal—a turn to huge, massive, unprecedented federal government outlays to drive the economy and attack numerous societal problems. The amounts being spent and to be spent, as a percent of GDP, are far greater than those of the Roosevelt New Deal and even World War II.

A 1930s-like turn to the federal government for direction and spending, huge deficit- and debt-financed and nearly fully accommodated by easy monetary policy, the shift in outlays in 2020–2022 of \$5.9 trillion, or near 28 percent of nominal GDP, has no offsetting outlay reductions nor tax increases as pay-fors.

That would come later, in a spend-and-tax 2022 federal budget proposed by the administration, a \$3.5 trillion ten-year program including more conventional federal government outlays on infrastructure (\$600 billion), and items under a new category, human infrastructure, such as health care, education, child care, student debt forgiveness, and climate change, funds to compete on the U.S. form of capitalism against China, as well as supporting low-income and disadvantaged Americans with tax increases on higher incomes and corporations to rebalance the huge inequality of income, wealth, education, and medical care that exists.

In the short run, through the rest of 2021 and 2022, enough fiscal firepower exists that the United States will not run out of ammunition.

The economy should grow strongly, far above trend; price inflation should pick up with the risk dangerously so; the unemployment rate should fall; but with the federal budget deficit at record highs of 15–20 percent of GDP and federal government debt-to-GDP ratios as high as 125 percent plus.

The United States may feel good in the short term but in the longer run the unprecedented higher deficits and debt will come back to haunt America in unacceptably high inflation, market- and then Federal Reserve-induced much higher interest rates, federal government debt

service-to-GDP ratios that will be onerous and burdensome, a declining dollar, a slowing U.S. economy, stagflation, and no more ammunition left for further fiscal stimulus to support the economy.

Indeed, the payoff to the economy, jobs, and to public welfare from this Washington “New” New Deal is, on the basis of history, questionable.

Historically, large federal government outlays, nowhere near what is in-train and contemplated now, financed by deficits and debt-financed, during the 1960s (Vietnam War), 1980s (Reaganomics), and post-Iraq War (2005–2008), have led to instability, inflation, or stagflation, financial crises then recessions.

While not inevitable, avoiding such outcomes will require the economy to produce stronger-than-expected tax receipts with payoffs on fiscal stimulus not seen before, and a careful and efficient functioning of the federal government.

In the next two years, the pluses to the economy from the fiscal stimulus will make America feel good. The unemployment rate will likely fall toward full employment. This will stave off a day of reckoning.

But such a day has always come, the day when a sovereign debt crisis engulfs a nation that has spent, deficit- and debt-financed, with later debt service burdens so onerous that the central government no longer has the ability to provide any fiscal stimulus.

The promise of the “New” New Deal is the economic and societal benefits that can come in the short run on the proposed central government policies.

The poison of such an approach is the long-run negatives that always have followed profligate and undisciplined central government spending beyond its means.



Important political and economic forces can limit how often the cannons can be shot.

MICHAEL MANDEL
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The United States is not likely to run out of ammunition for its “fiscal stimulus cannons” in the immediate future. However, important political and

economic forces can limit how often the cannons can be shot. Moreover, fundamental changes in the global economy—in particular, the increased emphasis on supply chains and data-driven consumption, investment, and trade—make it harder than ever before to determine how close the fiscal cannons are to overheating.

From a fiscal perspective, the U.S. government is in the enviable position being a safe haven for investment in a very uncertain world even as the country’s debt-to-GDP ratio climbs. Even if a large unnamed country decides that it wants to stop buying U.S. Treasury securities, plenty of other foreign investors are ready to shift money to the United States to take up the slack.

However, fiscal stimulus is not and cannot be a blank check. At some point, Americans will balk politically at leaving the next generation more debt to pay off. We may be close to the point where responsible politicians pay more attention to deficit-shy voters. An excessive debt-to-GDP ratio also makes the U.S. financial markets more fragile, by raising the odds that lenders and borrowers will eventually face a situation where corporate and consumer debt has to be refinanced in a rising-inflation, rising-interest-rate, depreciating-dollar environment.

How close are we to that red line? It’s hard to say. The debt-to-GDP ratio indicates the ability of the domestic economy to support the burden of servicing the outstanding public debt. In an era of volatile globalization and a U.S. economy increasingly driven by data, are we correctly measuring the denominator of that ratio?

Consider the impact of globalization. As the White House “100-day-supply-chain-review” makes clear, the global supply chains supporting the U.S. economy are essential, complex, and poorly understood. Moreover, the statistical tools used to incorporate supply chains into the calculations of GDP are underdeveloped. That makes it difficult to know how much of “domestic” GDP is located in the United States and how much is actually located abroad.

At the same time, today’s economic statistics likely undercount the contribution of data and other intangibles to consumption, investment, and net trade. Compared to twenty or thirty years ago, the magnitude of the undercounting may be significantly larger, explaining why the United States can support a larger debt-to-GDP ratio.

People can reasonably disagree about the appropriate amount of fiscal stimulus. But it’s clear that our statistical indicators for measuring the capacity and potential overheating of fiscal cannons need a lot of work.



For now, the United States has a ready reserve of ammunition.

MENZIE D. CHINN

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First, while federal debt held by the public has risen quickly, and is projected by the Congressional Budget Office to further rise from 100 percent in 2020 to 106 percent of GDP by 2031, the maximum debt-to-GDP ratio that can be sustained (and hence the gap between the two, sometimes considered a measure of “fiscal space”) is unknown, particularly for a country that issues debt in the global reserve currency. Add to that the fact that the real interest rate that we are paying on that debt is likely to be lower than the growth rate of GDP for a sustained period—the real ten-year interest rate has been stuck at about minus-1 percent for a year, and was close to 0 percent on the eve of the pandemic—then we have much more room to run a primary deficit (and stabilize the debt-to-GDP ratio) than if one thought real rates were going to rise back to 1.5 percent.

Second, another metric for assessing the amount of fiscal space—the debt-to-tax base—seems low if one takes the observed tax revenue as a measure. However, if tax revenues could be raised so that we collected the same revenue-to-GDP ratio as in 1979, then the deterioration in the fiscal space would be somewhat less worrisome; the debt-to-tax revenue would then be only a bit greater than at the end of the great recession. Of course, raising tax rates to raise tax revenues is difficult. In other words, fiscal space is partly a function of political will.

Third, what we spend our fiscal ammunition on matters. Spending on infrastructure has a bigger multiplier effect, in both the short and particularly the long term, than other types of spending. Given the current configuration of real government funding costs, it’s unclear whether greater expenditures on infrastructure investment would actually reduce fiscal space.

Finally, returning to the first point, the federal government funds in the U.S. dollar, which is the global currency. It can expect that a large portion of that debt will be readily purchased by foreigners, both central banks and private entities. That’s likely to be true despite rising

federal debt, if only because governments around the world are also issuing much more debt in the wake of the Covid crisis.

The real danger is that we will retrench too quickly in response to perceived, but illusory, constraints, thereby derailing growth. We’ve been there before, and we shouldn’t repeat that experience. For now, the United States has a ready reserve of ammunition, and we should be prepared to use it.



The Biden administration clearly spent at a pace that could not be maintained, setting up a negative fiscal impulse.

MARC SUMERLIN

Managing Partner, Evenflow Macro, and former Deputy Assistant to the President for Economic Policy and Deputy Director of the National Economic Council

Expansionary fiscal policy provides a boost to economic growth through the increase in spending. If spending increases at a slower rate, the impact on growth wanes, and if spending falls, the impact on growth is negative. The Biden administration clearly spent at a pace that could not be maintained, setting up a negative fiscal impulse. The Biden administration did not calibrate fiscal policy in a way that demand would meet supply, but rather made a political calculus to get as much spending as politically possible in Biden’s first year.

We can use the July Congressional Budget Office report to see how much fiscal contraction is built into the system. In FY 2022, individual taxes are expected to be \$375 billion above FY 2021 collections. Part of this is from the natural recovery of the economy and part of this is from the disappearance of stimulus checks. The bigger concern is a whopping \$1,273 billion drop in mandatory spending in FY 2022. Even if Biden gets another \$300 billion into the economy next year with bills yet to come this fall, that will still leave a 5 percent of GDP fiscal contraction.

This fiscal cliff needs to be viewed against the \$2 trillion in accumulated savings that could smooth spending out. This might delay some of the slowdown until 2023. Either way, a year or two of disappointment is baked in.



*The 2022 outlook
is tricky.*

JIM O'NEILL

Former Commercial Secretary to the Treasury, United Kingdom, and former Chairman, Asset Management, Goldman Sachs International

In terms of the U.S. economy in 2022, there are many imponderables of which the end of this year's huge fiscal stimulus and its waning is just one of many. One would imagine that the government is rather hopeful that some part of the fiscal stimulus, namely the investment element, as opposed to just the handing out of checks to individuals, will have some lasting effect. Indeed, they often talk about the multiplier consequences and hope it lifts trend growth. Obviously, this is rather optimistic but time will tell.

If the ending of the direct stimulus to consumers is the only part that has a positive impact, then its ending will certainly weaken growth, but it is hard to know in advance. There is so much else going on that it is not as though it is the only issue on the horizon. Unless the United States can improve its success of Covid-19 vaccinations, as we witness at the time of writing, it is susceptible to new outbreaks of the virus that in itself could weaken the economy again.

There are all the same issues for the rest of the world, and what this means for the interplay of the U.S. economy with the rest of the world in terms of trade and travel. Away from this issue remains the whole question of inflation and what the Fed is planning to do, which judging from their latest minutes, implies that the Fed is thinking of the environment being closer to one where they will consider some tapering and setting the scene for higher policy rates.

My own personal view is that 2021 will be a very strong year for global GDP growth because of the stimulus and running down of forced consumer savings in many places, but that the 2022 outlook is more tricky. I am frankly unsure whether it will be also another strong year or weaken considerably. What I do think more clearly is that this decade is going to have repeated challenges, with some of overhang of the monetary and fiscal excesses that have persisted for many years in the previous decade, as well as the issue of climate change, the never-ending dilemmas between the United States and China, and overhanging it all for the United States and many other

societies, the challenge of income and wealth equality and the temptation of policymakers to try and forcibly pursue policies for more equality. Below all of these issues lurks productivity, and here, I am a touch more optimistic that this awful crisis might have ushered in some changes that are showing signs of higher productivity as so many of us adapt to new ways of working.



*We are clearly not in
the red zone on the
fiscal tachometer.*

EV EHRLICH

President, ESC Company, former Undersecretary of Commerce, 1993–1997, and former Chief Economist and Head of Strategic Planning, Unisys Corporation

Granted, it's easy to overlook a fiscal policy problem with low rates making debt carrying costs all but irrelevant. And you can't increase borrowing forever at a rate greater than that of the base that supports it. There are limits.

But it's hard to argue the United States is up against its fiscal carrying capacity when only weeks ago the number of basis points in the ten-year Treasury yield was lower than the temperature in Oregon. The Treasury bond market—the economy's EKG—is far from signaling danger. Reinhart-Rogoff warnings notwithstanding, we are clearly not in the red zone on the fiscal tachometer.

Debt-phobics pass by the composition of spending the same way they elide the circumstances that have led and now lead to public debt. Financing pressing public needs—whether public infrastructure, broadband access, universal pre-K, or child care that facilitates labor supply—are radically different than serial tax cuts that provide nothing more than a fiscal sugar rush. As financier Felix Rohatyn once argued, today's Congress would have turned down the Louisiana Purchase. The problem with these policies is not financing them, but implementing them; witness, for example, a climate spending program that omits an essential carbon tax or an infrastructure plan without a central bank to rationalize the major investments.

Third, whether we will find ourselves without "fiscal ammunition" would be far better asked of monetary policy,

rather than fiscal. We have lived too close to the monetary policy boundary for too long, and while we scour the horizon for signs of transient inflation in a disinflationary global supply system, there are already signs that free money is contorting the economy—the roller coaster of cryptocurrencies, magical “NFTs,” huckster “meme stocks,” let alone QE-fed escalating home prices and Fed-supported asset prices generally. Low rates change the economy’s composition and character as much as high ones do.

Finally, none of these considerations are new. As a lad I sat on the knee of my undergraduate economics professors and learned about “crowding out.” Later, when I graduated into a borderless world, I learned about the “twin deficits.” But neither suffocating interest rates nor a plummeting dollar is either at hand or in prospect. So the question comes down to whether we should ignore important investments in physical and human capital right now because we might need those resources as part of a short-term program to counter a downturn down the road. That question answers itself.



I am moderately optimistic, but there are certainly risks to the downside.

STEVEN B. KAMIN

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The U.S. economy faces two important questions concerning the stance of fiscal policy. The first is whether the slated withdrawal of fiscal stimulus will unduly weaken economic activity and set back progress toward full employment. The second is whether, in the event that adverse shocks threaten to push the economy back into recession, the government has the fiscal space to provide renewed stimulus. I am moderately optimistic on both these issues, but acknowledge that there are certainly risks to the downside.

On the first question, fiscal policy is projected to subtract some 2.25 percentage points from U.S. GDP growth over the next year and half. But that contraction of demand will most likely be offset by strong growth in the

private sector. American households are holding as much as 9 percent of GDP in excess saving accumulated from generous stimulus checks and unemployment compensation. By the same token, a record \$6.9 trillion (30 percent of GDP) in cash and short-term investments are sitting on U.S. corporate balance sheets. Assuming that the Delta variant is brought under control and the economy continues to recover as expected, spending out of these treasure chests by households and firms should be more than enough to make up for reduced government spending. And this will all be against the background of near-zero interest rates, razor-thin credit spreads, and buoyant stock valuations. Indeed, the economy grew 6.5 percent in the second quarter of this year, despite fiscal policy removing 2.5 percentage points from that growth.

Of course, any number of adverse developments, but especially the uncontrolled spread of a new, stronger-than-Delta Covid variant, could upset this benign scenario. But despite a rise in the nation’s public debt (federal, state, and local) to a projected 133 percent of GDP this year, the U.S. government retains the fiscal space to ramp its stimulus back up again if recession were to threaten. Bond yields are already very low and would plummet further in such a scenario, reducing the cost of financing renewed large deficits. Indeed, with public debt loads having risen sharply around the world, U.S. Treasuries remain the preeminent flight-to-safety vehicle. And the example of Japan, with a debt-to-GDP ratio of over 250 percent and ten-year yields at zero, suggests that the United States has a very long way to go before hitting the fiscal wall.



The United States is not heading for a fiscal cliff in 2022.

HOLGER SCHMIEDING

Chief Economist, Berenberg

No, the United States is not heading for a fiscal cliff in 2022. One of the most common misunderstandings in the economic policy debate is that it takes a major fiscal expansion and/or a big monetary boost to generate sustained healthy growth in aggregate demand.

Yes, a well-timed stimulus can contain a recession, kick-start a recovery, and add some momentum to the rise in demand in any given year. But well-run economies with a vibrant private sector are fully capable of expanding at a solid clip without permanent help from Uncle Sam or other fiscal agents. Apart from exceptional periods of insufficient private demand, the best contribution that fiscal policy can make to growth is to inspire confidence, provide adequate welfare benefits, and finance public goods as well as long-term investments into infrastructure, research, and technology to enhance the supply potential of the economy.

In response to the pandemic, the United States opened the fiscal taps in 2020 and early 2021 like never before. Arguably, Uncle Sam went overboard by raising real disposable incomes of U.S. households by 6 percent in real terms in 2020. Going forward, the United States will most likely not send out further stimulus checks and may scale back other measures of support for households. As a result, the rise in real disposable incomes is now taking a breather that will last until the accelerating gains in labor incomes more than offset this effect. But that should not be misunderstood as a “fiscal cliff.” Much of the money sent to households during the first waves of the pandemic is still sitting on the balance sheets of the recipients. With excess savings relative to normal accumulated from March 2020 through May 2021 worth 24 percent of pre-pandemic household expenditures in 2019, U.S. consumers can keep spending without further fiscal largesse.

Now consider the monetary angle. Doesn't the Fed's upcoming tapering of asset purchases, likely to be followed by its first rate hikes in the second half of next year, need to be offset by a fiscal expansion to prevent a shortfall of demand? This gets the logic upside down. With its dual mandate and its increased tolerance of inflation overshoots, the Fed will only scale back its stimulus if the economy performs sufficiently well. Taking the foot off the accelerator in an economy that has reached cruising speed should not be confused with stepping on the brakes. Or to put it differently: when the emergency is over, emergency support must stop—just like the fire brigade must shut off the hose once the fire has been extinguished.

Consider the unlikely tail risk: If a dramatic resurgence of the pandemic were to force the United States into renewed lockdown or if any other black swan shock were to derail the U.S. and global economies, the resulting capital flight into the world's biggest safe asset, U.S. Treasuries, would once again allow the United States to borrow whatever it would need to stabilize its economy. Let's pray it won't come to that. But if so, the United States would not be short of fiscal and monetary ammunition.



There is still flexibility to provide more fiscal support if the economy were to fall into recession next year.

MICKEY D. LEVY

Chief Economist for the Americas and Asia, Berenberg Capital Markets

While U.S. fiscal policymakers were far too aggressive in deficit spending in response to the pandemic and government shutdowns, particularly through excessive unnecessary income support for those who didn't need it, there is still flexibility to provide more fiscal support if the economy were to fall into recession next year or if another emergency were to occur.

The U.S. economy is highly successful, with the highest sustainable potential growth among all advanced nations. This makes the surge in government spending and the higher debt manageable, but they are not costless. The U.S. Treasury will continue to be able to issue bonds and service its debt service costs. But realities are that we and future generations will pay for the surge in spending, one way and another. Proclamations of “running into a fiscal cliff” get headlines, but the higher probabilities are outcomes that involve slower potential growth, higher inflation and higher interest rates, and less government resources available to allocate to future needs. Fiscal policymakers must be more thoughtful and judicious about government spending and acknowledge there are tradeoffs.

The government fulfilled its proper role of providing income support to individuals and suffering small businesses in response to the pandemic and government shutdowns, particularly with the CARES Act of March 2020 that involved approximately \$3 trillion in deficit spending. However, the subsequent \$900 billion of deficit spending legislation enacted in December 2020 and President Biden's additional \$1.9 trillion in March 2021 when the economic recovery was already strong was unnecessary as countercyclical stimulus. Most of that spending involved direct government transfers—writing checks—to individuals, the vast majority of whom who were employed, and grants to states whose finances had already significantly recovered from the pandemic.

Government debt has soared and debt service costs will rise far into the future, even if bond yields remain low. The U.S. economy is growing solidly, and it does

not require ongoing floods of fiscal stimulus to sustain growth. Policymakers must be more thoughtful about how fiscal legislation allocates resources and the implications for current and future economic activity and longer-run government finances.

The same critique is applicable to monetary policy. The Fed's initial responses to the unfolding pandemic and severe dysfunction in the Treasury debt market—reducing rates to zero and massive purchases of Treasuries—was necessary. But continuing these emergency policies well after the economy has stabilized and markets have regained normal functioning is unnecessary. It serves primarily to pump up financial markets. Inflation has risen far above the Fed's forecasts and delaying normalization of monetary policy is distorting financial markets and is inconsistent with financial stability. Moreover, the Fed's ongoing purchases of so many Treasury securities reduces the government's debt service costs and facilitates the misplaced perception that fiscal profligacy is costless. Similar to fiscal policymakers, the Fed needs to think more strategically about the longer-run implications of its current policies.



There is no danger that the United States will run out of fiscal ammunition.

JAMES E. GLASSMAN
Head Economist, JPMorgan Chase & Co., Commercial Bank

There is no danger that the United States will run out of fiscal ammunition. The important lesson from the Great Depression long ago, which policymakers regardless of their political leaning implicitly have come to embrace, is that the more aggressive the policy response to an economic crisis, the more limited the social and economic damage. Prolonged economic downturns lead to lost opportunities with significant negative implications for future potential growth. And that's why worries about the availability of fiscal ammunition need to be weighed against judgments about the economic consequences of a timid fiscal response.

A stylized fact of all past business cycles is that interest rates have tended to fall in recessions despite supportive fiscal initiatives and expanded government credit

needs. That's because the federal government's expanded credit needs are outweighed by a decline in private credit demand. Washington's bold response to last year's pandemic lockdowns, the most aggressive fiscal response in history, is as commendable as it is surprising in the face of a polarized body politic. And it is clear evidence that our elected leaders have few qualms about using the nation's fiscal tools when economic circumstances call for such actions.

The proof of the appropriateness of the fiscal response to the Covid-19 pandemic, which for sure has led to an eye-popping surge in federal debt to levels in relation to the size of the economy not seen since the conclusion of World War II, is evident in the economy's unprecedented rebound from the dislocations caused by last year's social distancing lockdowns. The National Bureau of Economic Research's business cycle dating committee, the official referee of economic cycles, concluded that the 2020 economic collapse lasted for two months, with the economy peaking in February 2020 and bottoming in April 2020. National output now is roughly back to where it would have been had there been no pandemic. Profit margins have swelled to a post-World War II record high. And the equity market has surged 35 percent since lockdowns were imposed and stands at an all-time record in absolute terms and relative to the size of the U.S. economy.

It could have been argued prior to the pandemic that the nation had limited fiscal options, with the federal deficit running at a historically high 5 percent of GDP and the debt burden high and rising. And yet, in the face of the economic crisis, Washington authorized the release of \$7 trillion of fiscal rescues in the eleven months following the lockdowns, according to the nonpartisan Committee for a Responsible Federal Budget.

Federal support now can wind down in coming months without creating new dangers because the economy has recovered much of the ground that it lost during last year's lockdowns. For example, national output is already back to where it would have been in the absence of the pandemic. Employment is 7.5 million jobs shy of where it would have been and this dichotomy is a reflection of aggressive innovation by businesses who had to learn how to survive. And hopefully the flareup of the Delta variant of the SARS-CoV-2 virus will bolster efforts to hasten the vaccination drive. At the same time, support from the Federal Reserve's highly accommodative stance will remain in place for several more years.

There is no danger of running out of fiscal ammunition, and aggressive responses to economic crises are appropriate. But the nation faces a daunting long-term challenge, not because of the fiscal response to the pandemic and the significant volume of outstanding debt in its wake, but because, looking far ahead, the economy is not expected to grow quickly enough—not as quickly as it has

in the past—to generate enough public sector revenues to pay for its commitments.

Our elected leaders should be proud of their response to the economic crisis. The aggressive U.S. fiscal response did not deplete the nation’s reservoir of support—there is no danger of running out of fiscal ammunition. But now that the economy is quickly normalizing, it is appropriate to turn focus back on the nation’s longer-term fiscal challenges. The go-to remedies—trim the promises or raise taxes—almost certainly would do more harm to the economy and so dampen revenues. Pro-growth initiatives are the best way to address the nation’s long-term fiscal challenge.



The United States is under no serious risk of running out of fiscal ammunition. The bond market is not intimidating anyone.

RICHARD JERRAM
Chief Economist, Top Down Macro

Recent years—even pre-pandemic—have forced us to re-think views on how much government debt an economy can support. As with many of today’s policy conundrums, Japan led the way. It piled JGB upon JGB, with only occasional reference to fantasy projections of achieving the primary fiscal balance that would allow it to stabilize debt ratios.

The key lesson was that zero interest rates skew debt dynamics. Mathematically, this might seem obvious, but it still felt like a surprise to financial markets. Of course, you don’t really want to be in the situation where zero rates are necessary, but once you are there—and the central bank is hoovering up a large part of new debt issuance—old fiscal rules go awry. For this to be a permanent state would require a form of modern-day alchemy, but short-term policy constraints have been loosened.

As a result, the United States is under no serious risk of running out of fiscal ammunition. James Carville might be surprised to find the bond market is not intimidating anyone, with a ten-year yield around 1.3 percent (at the

time of writing), but there is no pressure to rein in the budget deficit too aggressively.

A better question is whether it makes sense for the United States to run such large deficits. With the unemployment rate at 5.4 percent, it is hard to see the need for policies to support overall demand. Cutting the deficit looks prudent, even if there is no urgency. However, such low borrowing costs offer justification for investments that could bring longer-term benefits, in physical or social infrastructure, or to mitigate climate change, which points to running wider deficits than would normally be the case.

The problem is that sustained fiscal profligacy could lead to inflation, which in turn would bring pressure for higher interest rates. Alternatively, a looser fiscal policy would imply—all else being equal—a tighter monetary policy. And either outcome could make many things unravel.



The ammunition to fight future slumps or to deal with recurring rounds of Covid will likely be there.

WILLIAM T. DICKENS
University Distinguished Professor of Economics and Public Policy, Northeastern University, former Brookings Fellow, and former Senior Economist, President Clinton’s Council of Economic Advisors

There is no end in sight to the demand for U.S. debt and thus no visible bottom to the ammunition supply for fiscal policy. Interest rates on long-term Treasuries remain near historic lows, suggesting that there is plenty of room to further expand U.S. debt. Should we need it, the ammunition to fight future slumps or to deal with recurring rounds of Covid will likely be there.

On the other hand, the ability to use fiscal policy to further accelerate growth likely is limited. Particularly with the continuing Covid crisis around the world, bottlenecks are already causing inflation and the Federal Reserve will certainly raise interest rates and choke off growth should it appear that medium- or long-term inflation expectations are rising much above their 2 percent inflation target. ♦