

Robert E. Rubin**Prepared Remarks****Delivered at the Conference "Rethinking Macroeconomic Policy" at the Peterson Institute for International Economics, Washington DC, October 12, 2017**

Thank you for inviting me to comment on rethinking fiscal policy. I'm going to do so in the spirit of Fischer Black, who some years after leaving MIT for Goldman Sachs, said, albeit in a different context, that markets looked different from the banks of the Hudson than from the banks of the Charles.

I am going to describe what I think are five effects of America's unsound fiscal trajectory, and of any actions that worsen that trajectory, all of which effects, in turn, can negatively impact growth. And, in my view at least, the analysis relating to each of these five adverse effects is directly germane to rethinking fiscal policy.

Before I turn to these effects, let me make a few quick comments. First, I put this in an American context, but the points apply broadly. Second, I discuss this for a full employment economy, but at the end, I will turn to an economy with slack labor markets. Third, the effects of fiscal policy decisions can, to state the obvious, be significantly affected by the economy's fiscal context, as captured by the debt/GDP trajectory. On that score, Auerbach is concerned that "implicit liabilities" are not represented on a present value basis, but I think the data is adequate because these liabilities are captured in longer-term debt/GDP trajectories. Finally, the uncertainty inherent in any conclusion about the impact of fiscal policy decisions should be included in fiscal decision-making, a point made in the Blanchard/Summers paper.

The five adverse effects are:

1) Negatively affecting business confidence, by creating uncertainty about future policy and by heightening the concern about our political system's ability to meet our challenges. Economists have difficulty measuring business confidence, and tend not to include it in their analyses, but that doesn't make it any less real. The 1993 deficit reduction program, I think, clearly significantly improved business confidence, and thus investment and growth. And, the fiscal conditions of the preceding period had a major negative effect on business decisions, for the reasons I just mentioned, which I heard repeatedly from corporate clients when I was at Goldman Sachs.

2) Reducing resilience to deal with future economic or geopolitical emergencies.

3) Reducing funds available for public investment, by increasing interest costs as a percentage of the budget wherever rates may be, and by increasing the risks of deficit-funded public investment.

4) Increasing sovereign and private market interest rates because of increased demand for the supply of savings and/or because of increased psychological concern about future imbalances, inflation and interest rates. Moreover, markets sometimes have tipping points, where some relatively minor event can focus attention on, and catalyze reaction to, long-ignored risks. For example, a limited increase in the debt/GDP ratio from additional borrowing could produce a step function, rather than a linear, effect on sovereign debt costs, when there is a risky intermediate and longer-term debt/GDP trajectory. And that, in turn, could affect private sector interest rates, by increasing the safe rate, and by widening spreads because of heightened concern. These market dynamics, it seems to me, are the problem with the hypothetical discussed by Blanchard and Summers of the government borrowing indefinitely when R is less than G , because it won't stay that way. And, they do go on to

suggest that their hypothetical may be an unsustainable Ponzi scheme. In any case, this is a more elaborated version of crowding out. The ability to borrow in your own currency, and print it via the central bank, may diminish this risk. But levitation through borrowing and printing has its limits, and at some unpredictable point can undermine both the currency and the debt markets. Capital inflows can also alleviate interest rate pressure, but, again, unsound fiscal policies can sooner or later adversely affect confidence and thus those inflows. Extensive liquidity may modulate market pressures, but, in my view, liquidity is not just a monetary phenomenon but a psychological one, and when the psychology changes, liquidity can disappear quickly as funds rush to Treasury bills to avoid risk.

5) Finally, if fiscal conditions come to be seen as sufficiently serious, the market dynamics I described earlier can lead to severe market and economic destabilization. Moreover, markets can ignore or underweight risks, including fiscal risks, for long periods—until they don't, and then the reaction can be rapid and savage. The sovereign debt of the fiscally weaker countries in the Eurozone traded at tight spreads to German Bunds for years, until suddenly and catastrophically, they didn't and spreads exploded.

It follows that the cost of funds in borrowing for a new project, such as infrastructure or a tax cut, whether in a full employment economy or in an economy with labor market slack, is not just the interest cost on that project, but the possible impacts on future borrowing costs of the federal government and the private sector and all of the other possible adverse effects I've just discussed, even though many cannot be quantified. The Auerbach paper alludes to this complexity.

Thus, analyzing any particular deficit-funded proposal involves estimating the measure's growth effect, adjusting downward for various adverse effects of the new debt net of

realistic positive or because of the debt negative dynamic scoring, calculating a revised debt/GDP ratio, and then determining whether that would have any additional effect on growth. This as an iterative process, but could be solved in one calculation with simultaneous equations.

In an economy that has substantial unemployment, deficit funding obviously can provide a shorter-term stimulus, while also being used in ways that boost productivity. But all of the negatives I've just discussed still apply, in evaluating the effects on growth for the current period and for the longer term, including, as Auerbach observes, of market concern about the risk of fiscal crisis. However, there could also be a positive impact on business and market confidence, from the additional demand and its potential effect on growth and tax revenues.

Whether any given stimulus proposal is good policy for the short-term and over time depends on weighing all of these factors. The Auerbach paper states that shorter-term stimulus should be combined with measures that address longer term structural issues, and that's certainly right. But the political reality is that a credible commitment to longer-term fiscal sustainability is exceedingly unlikely, at least in the U.S., and I would guess more broadly, for the foreseeable future.

Along the same lines, in theory, surpluses seemingly should be generated during good times to roll back any increase in debt/GDP that may have occurred from stimulus during weak economic times. But when surpluses can be achieved, that potential is generally used for tax cuts or spending increases. Thus, the debt/GDP ratio seems likely to ratchet up over successive business cycles, which should enter into decision-making about the expected value over time of a stimulus proposal.

In addition, stimulus, unless it has an extraordinarily high multiplier, either *ab initio* or from a self-perpetuating virtuous cycle, even including the effects of hysteresis, seems to me

unlikely to pay for itself. But that is a judgement to be made through weighing and balancing of all the relevant variables. Also, that still leaves the critical question of how the debt/GDP ratio is affected, initially and over the longer term.

Auerbach says that support for contractionary fiscal policy in either weak or crisis economic conditions is diminishing. My view is that this is a judgment that should be made based on the facts of any given situation. Weighing and balancing the economic effects of alternative policy paths, there are conditions, again in my view, where contractionary policy in a weak or crisis economy is either the most likely to succeed or necessary.

I have already cited the U.S. 1993 deficit reduction program in the face of shaky economic conditions, which I believe contributed substantially to the recovery that followed, not simply because of interest rate effects, but also because of the effect on business confidence. And, in response to the Mexican financial crisis in 1995 and the Asian crises later in the decade, fiscal tightening, though contractionary, was necessary to reestablish bond market and economic stability and recovery versus the alternative of expansionary fiscal policy that would likely have fed an ever deeper and prolonged economic crisis.

My impression is that the same requisite for improving fiscal conditions applied in the early stages of the Eurozone crisis, though that left the question of when this should have been eased.

To conclude, advocates of deficit-funded spending or tax cuts always find reasons – whether sound or spurious – to justify the deficit funding. And, in some circumstances, it is the optimal policy path, but it seems to me that there is a strong tendency to ignore or underweight the risks, and potential adverse effects, including those that are real but that cannot be quantified.

And, that will likely create increasing costs over time and likely ultimately force even harsher remedial actions.