FULCRUM

New fiscal theory and the US election

by Gavyn Davies*

As the US elections approach, the intellectual climate in America is undergoing a major change in the mainstream attitude towards fiscal policy. Under the so called "New View", fiscal policy should be accorded a greater role than before in stabilising the economy during the cycle, and should be more stimulative in the long run to promote supply side improvement. Although the driving force for these changes stems from Democrat-leaning economists, both the Presidential candidates have proposed fiscal packages which contain elements of the New View. However, the likelihood of a major shift towards fiscal stimulation is reduced by two obstacles: the Federal Reserve and political gridlock. The New View may not really come into its own before the next US recession is at hand.

Presidential elections have often marked major changes in American attitudes towards fiscal policy.

The arrival of President Kennedy in 1960 represented the beginning of Keynesian fiscal activism. President Nixon's election in 1968 marked the high point of inflationary budgetary policy designed to finance the Vietnam War.

President Clinton in 1992 ushered in a period in which the reduction of public debt was paramount. The elections of President Reagan in 1980, and George W. Bush in 2000, marked eras in which tax cuts took precedence over budget balance, and counter-inflation policy was ceded to the Federal Reserve.

As the 2016 election approaches, investors are wondering whether another major change in the approach to fiscal policy is in the works. Is a lurch towards fiscal stimulus the "next big thing" in Washington? Possibly, but I am not convinced.

The intellectual climate is certainly shifting. Jason Furman (once called the "wonkiest wonk in President Obama's White House"[1]) has outlined a "New View", under which fiscal policy is more active and more stimulative in future. Blinder (2016), an adviser to Hillary Clinton, has written in similar terms. Paul Krugman, Lawrence Summers and Brad DeLong have been arguing for years that fiscal policy should be eased to reduce the pressure on monetary policy, which is clearly over-burdened when interest rates are close to the zero lower bound (see Krugman, 2016 and DeLong and Summers, 2012).

These authors, although clearly affiliated to the Democrats, reflect a broader consensus among mainstream macro-economists, a consensus that has changed markedly since 2008. The IMF (see Gaspar et al., 2016), and many central bankers,[2] increasingly support this New View. So what does this imply for policy in the next four years?

Before 2009, almost everyone had come to believe that economic stabilisation should be left to monetary policy, with fiscal policy playing no substantive role. This consensus began to change after the great financial crash in 2008, when the Obama

*Correspondence: <research@fulcrumasset.com>, Department of Macroeconomic Research, Fulcrum Asset Management LLP, 66 Seymour Street, London W1H 5BT.

[1] "Economist Jason Furman is the wonkiest wonk in the White House," Washington Post, 12 February 2014.

[2] "Semiannual Monetary Policy Report to the Congress," Chairman Ben S. Bernanke, 26 February 2013.

administration explicitly viewed an emergency fiscal stimulus as necessary to avoid a second Great Depression. The administration pushed through a discretionary stimulus worth 2 per cent of GDP, and the automatic stabilisers in the budget added another 2 per cent.

Opponents argue that this stimulus failed to prevent a prolonged recession, and a sub par recovery. Supporters reply that its main failing was that it was too small to deal with the scale of the problem, and that it was reversed too soon, but they claim that it still prevented a calamity.

Much of the stimulus was reversed from 2011-14, when congressional Republicans successfully pressed for measures to bring down the budget deficit. Since 2014, the budgetary stance has been broadly neutral but macro-economists have been busy re-thinking the role of fiscal policy. The resulting New View has several key strands, many of them very familiar to old-style Keynesians.

Fiscal policy is once again seen as effective in stimulating aggregate demand, especially when interest rates are constrained by the zero lower bound. The Keynesian multiplier is viewed as unusually high in such periods. Monetary policy is believed to be severely constrained in the case of a new recession, so fiscal policy would be the only game in town. And fiscal stimulus would be much more effective if it were co-ordinated with similar action in other countries.

Furthermore, the medium term outlook for public debt is less troubling than it once seemed, because real interest rates have fallen relative to GDP growth. This makes it less urgent to correct the projected rise in public debt as the aging of the population takes effect in coming decades.

Finally, the New View believes that fiscal policy should be used as a supply-side strategy, not just as a means of stabilising demand. A boost to public infrastructure spending can be easily afforded with real interest rates below zero. Simulations show that this might increase the path for GDP sufficiently to reduce, not increase, the debt/GDP ratio in the medium term.

When the intellectual climate changes, politics and public policy often follow. Will it happen this time?

Hillary Clinton's budgetary proposals bear some of the hallmarks of the New View, incorporating a boost to infrastructure and other spending that would be partly financed by higher taxation. The debt ratio would rise from 74 per cent of GDP to 86-90 per cent in the next decade. However, the Clintons have always been in favour of budget balance, so she may not completely swallow the New View.[3]

The Trump budget package would involve large tax reductions that would not be offset by cuts in non-defence spending, so the budget deficit would rise immediately and the debt ratio would surge to 105 per cent of GDP in a decade. It would be similar to the Reagan approach, when the supposed incentive effects of lower taxation were thought to be much more important than short term budgetary discipline. Although Donald Trump's campaign makes ambitious claims for the effect of this package on GDP growth, few economists share this optimism. The result could be an extreme version of the New View, albeit with a very different emphasis between tax cuts and extra spending.[4]

Whoever wins on Tuesday, a pivot towards fiscal stimulation is likely to run into obstacles from two sources. First, in the current economic cycle, the US economy has passed the point when expansionary fiscal policy is needed to come to the aid of monetary policy in boosting demand. Instead, with the economy at full employment, the issue is how far to tighten overall economic policy in order to hold inflation within target.

If fiscal policy is eased, it is highly likely that the

[3] "Promises and Price Tags: An Update," Committee for a Responsible Federal Budget, 22 September 2016.
[4] "Adding Up Donald Trump's Campaign Proposals So Far," Committee for a Responsible Federal Budget, 9 May 2016.

Fed would respond by raising interest rates more rapidly than otherwise. This may still be a healthier policy mix than we have at present, since higher interest rates might reduce the risks of excessive risk taking in the financial markets. And the equilibrium real interest rate would rise, giving the Fed more scope to ease monetary policy in a renewed recession.

Although these advantages are clearly included in the New View, they relate to the fiscal/monetary mix, not to fiscal stimulus per se.

The second obstacle is much more obvious: political gridlock under the divided government that will probably emerge next week. Although Democrats and Republicans both seem to favour some overall fiscal stimulus, with mixed emphasis on medium-term debt sustainability, they do not agree at all on the balance between tax cuts and extra spending, or the nature of any such changes.

Under Barack Obama, these disputes blocked any shift towards stimulative budgetary policy after 2010, and the same may be true after Tuesday. The New View may not really come into its own before the next US recession is at hand.

References

Blinder, A. S. (2016): "Fiscal Policy Reconsidered," *The Hamilton Project, Brookings.*

DeLong, B. and L. Summers (2012): "Fiscal Policy in a Depressed Economy," *Brookings Papers on Economic Activity.*

Gaspar, V., M. Obstfeld, and R. Sahay (2016): "Macroeconomic Management When Policy Space Is Constrained: A Comprehensive, Consistent, and Coordinated Approach to Economic Policy," *IMF.*

Krugman, P. (2016): "Debt, Diversion, Distraction," *The New York Times.*

Disclaimer

Source: This note is based partly on material which appeared in an article by Gavyn Davies published in the Financial Times on November 6th.

This material is for your information only and is not intended to be used by anyone other than you. It is directed at professional clients and eligible counterparties only and is not intended for retail clients. The information contained herein should not be regarded as an offer to sell or as a solicitation of an offer to buy any financial products, including an interest in a fund, or an official confirmation of any transaction. Any such offer or solicitation will be made to qualified investors only by means of an offering memorandum and related subscription agreement. The material is intended only to facilitate your discussions with Fulcrum Asset Management as to the opportunities available to our clients. The given material is subject to change and, although based upon information which we consider reliable, it is not guaranteed as to accuracy or completeness and it should not be relied upon as such. The material is not intended to be used as a general guide to investing, or as a source of any specific investment recommendations, and makes no implied or express recommendations concerning the manner in which any client's account should or would be handled, as appropriate investment strategies depend upon client's investment objectives.

Funds managed by Fulcrum Asset Management LLP are in general managed using quantitative models though, where this is the case, Fulcrum Asset Management LLP can and do make discretionary decisions on a frequent basis and reserves the right to do so at any point. Past performance is not a guide to future performance. Future returns are not guaranteed and a loss of principal may occur. Fulcrum Asset Management LLP is authorised and regulated by the Financial Conduct Authority of the United Kingdom (No: 230683) and incorporated as a Limited Liability Partnership in England and Wales (No: OC306401) with its registered office at Marble Arch House, 66 Seymour Street, London, W1H 5BT. Fulcrum Asset Management LP is a wholly owned subsidiary of Fulcrum Asset Management LLP incorporated in the State of Delaware, operating from 350 Park Avenue, 13th Floor New York, NY 10022.

© 2016 Fulcrum Asset Management LLP. All rights reserved.