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Monetary Policy and the Fiscal Challenge

It's not a surprise that the President and Congress are struggling to reach an agreement on fiscal issues. In the financial crisis, the government used expansionary fiscal policy by running very large deficits in hopes of stimulating the economy. But this led to very large budget deficits and a huge increase in the ratio of government debt to GDP. Those deficits are not sustainable, so spending must be reduced or taxes increased, or both.

The fiscal challenge facing us is large, as Chart 1 suggests. There are a number of remarkable features in the chart, which plots several categories of government spending and income. First, note that federal government purchases, which is a measure of all current spending by the federal government, such as paying salaries of workers, is about 8% of GDP now, compared with 10% in 1960. That category reached its lowest point in 2000, when it was a bit below 6% of GDP. At 8% of GDP now, it is a bit higher than it was in most of the 2000s, but lower than it was in most of the 1960s to 1980s.

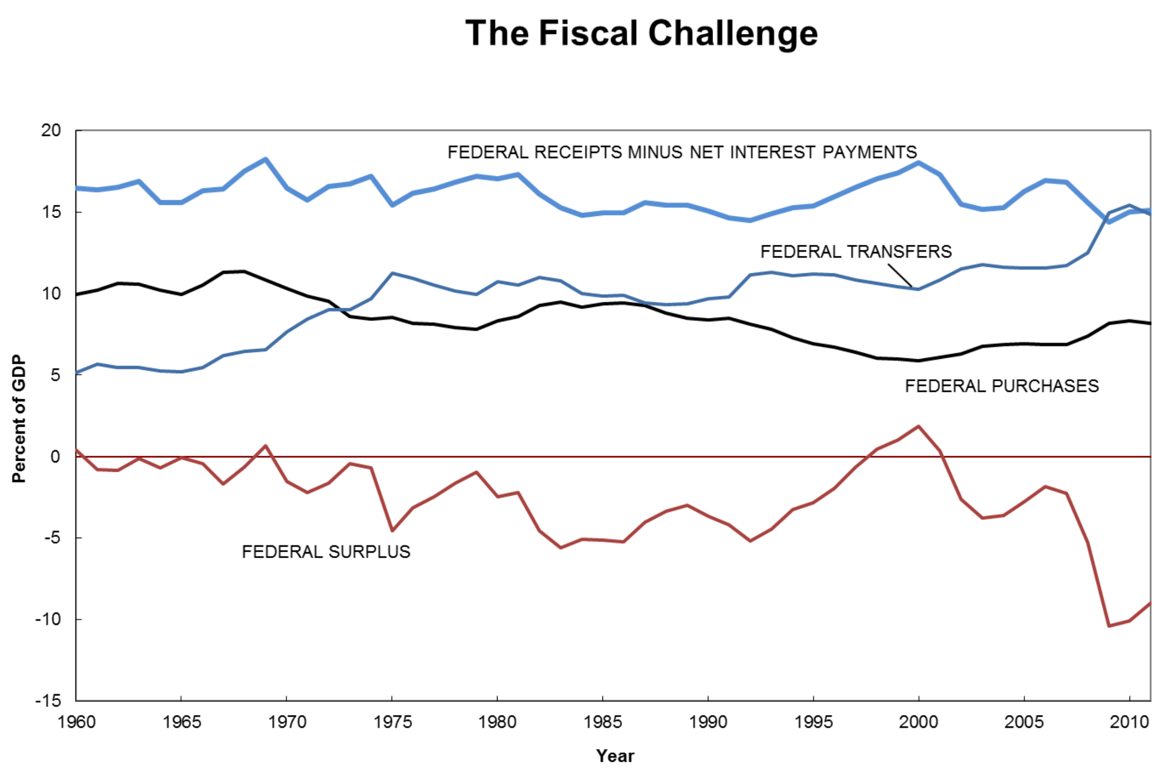

Chart 1. The Fiscal Challenge. Data from 1960 to 2011 shows very large deficits from 2009-2011, mostly arising from a large rise in transfer payments and a decline in tax collections.

Next, take a look at the line labeled "Federal Receipts Minus Net Interest Payments." That line shows that the amount of net tax collections, after paying interest on the government debt, is about 15% of GDP and is not far from its average over the past 50 years of 16%. It had been close to 17% before the financial crisis in 2008.

The biggest change in the graph is in the line labeled "Federal Transfers" which includes Social Security, Medicare, and Medicaid. Transfers have risen from about 5% of GDP 50 years ago to 15% of GDP today, and increased from a bit under 12% before the financial crisis.

Astonishingly, the line showing receipts is now at about the same level as the line showing transfers, each at about 15% of GDP. So, taxes cover none of the payments for government purchases, including wages for all government employees, which amount to over 8% of GDP. So, we borrow, mostly from abroad, to pay for all the services provided by the federal government.

What's not shown on the graph is that the problem is expected to get worse in the future. Under current laws, the amount of federal transfers will continue to rise significantly as a percent of GDP, and deficits will continue to be large enough to increase the ratio of government debt to GDP. So, Congress and the President have a big job to do.

It is likely that fiscal policy will tighten this year, as the tax increases recently enacted are likely to be followed by some cuts in government spending. This will reduce the deficit, but if the reduction in fiscal stimulus to the economy is large, the shock will also likely shift the aggregate demand curve to the left, possibly pushing the economy into a recession. How should the Fed react to this? In normal times, the Fed would want to stimulate the economy by reducing short-term interest rates. But since those rates are already near zero, the only thing the Fed can do is to buy bonds in the open market. The Fed's decision in December to increase the size of the monetary base by buying long-term bonds might reflect, in part, the Fed's concern about the impact of fiscal tightening on the economy. So, the Fed is already in the process of offsetting the government's actions to tighten its belt.