How Much Should We Worry About Debt, Inflation, and Unemployment?

Lane County Medical Society
Eugene Hilton

March 5, 2013

Mark Thoma
Department of Economics
University of Oregon
Introduction

• Three big worries dominate news coverage on economics:
  – The national debt
  – Long-term unemployment
  – Inflation

• How much should we worry about each of these problems?

• Attacking some problems makes others worse, at least in the short-run, so which is the most important problem to address right now?
Unemployment

- The unemployment rate is currently 7.9%. 12 million unemployed, 800,000 discouraged workers, 8 million people are working part time but would prefer full-time jobs. A broader measure of underemployment stands at 14.4 percent, nearly double the 7.9 percent "headline" rate
- The rate for some groups is very high, e.g. 14.3% for blacks, 14.2% for ages 20-24. But it’s only 4.6% for married men.
- It is falling much too slow (as in last two recoveries -- Autor’s “hollowing out”).
- Long-term unemployment (>26 weeks) is 36.1% of total unemployment. It is abnormally high.
- Appears to be mostly cyclical rather than structural
The Unemployment Rate
Long-Term Unemployed
Long-Term Unemployment is Costly

- Loss of output (a 1% increase in unemployment causes approx. a 2% drop in output, approx. $340 billion per year for every 1% increase in unemployment)
- Loss of skills
- Marked as “damaged goods” which harms employment prospects
- Long-term unemployed get discouraged and search less, drop-out of labor force
- Take work that does not match talents, get locked in
- Move to underground economy (less efficient, lost taxes)
- Higher cost for social services
Who Are the Long-Term Unemployed?

http://www.frbsf.org/publications/economics/letter/2013/el2013-03.html
The Debt and the Deficit

• How the debt and the deficit differ
  – The deficit is (gov spending + interest – taxes) in a given year. If it’s negative, it’s a surplus
  – The debt is the accumulation of all past deficits and surpluses

• By 2023, if current laws remain in place, debt will equal 77% of GDP

• The deficit for this fiscal year is projected to be $845 billion, or 5.3% of GDP
Source of Current Deficit

http://www.cbpp.org/cms/index.cfm?fa=view&id=3873
Long-Run Debt Burden

Figure B-1. Noninterest Spending and Revenues Under CBO’s Long-Term Budget Scenarios Through 2087

http://www.cbo.gov/publication/43288
Source of Increases in Spending

Source: Congressional Budget Office.

http://www.cbo.gov/publication/43288
How Much Additional Debt Reduction is Needed?

Figure 1
$1.4 Trillion in Additional Deficit Reduction Would Stabilize the Debt

Debt as a percent of GDP

88%
84%
80%
76%
72%

- Ratio without BCA or ATRA
- Ratio with BCA but not ATRA
- Ratio with BCA and ATRA
- Ratio with BCA, ATRA, and $1.4 trillion more savings

Notes: BCA stands for the Budget Control Act, August 2011; ATRA stands for the American Taxpayer Relief Act, January 2013. Source: Center on Budget and Policy Priorities based on Congressional Budget Office and Joint Committee on Taxation data.

http://www.cbpp.org/cms/index.cfm?fa=view&id=3885
Does Debt Hurt the Economy?

• Near full-employment, it can. In normal times, an increase in debt raises interest rates, that slows investment, and that can reduce future growth (and at very high levels, default can be an issue).

• So the borrowed money must be used in high-valued ways to make it worth it to take on more debt.
Does Debt Hurt the Economy?

• In a recession, it’s different. Presently, there are a lot of idle funds in banks (graph), so when the government borrows money, there is no pressure for interest rates to rise.

• Thus, since interest rates do not rise the effect on future growth is very low, and it’s much more likely that spending, e.g. on infrastructure, will have net positive benefits.

• Among those benefits is a reduction in unemployment.
Does Debt Hurt the Economy?

• In short-run, no sign that markets are worried (in fact, want more of it than is available due to “flee to safety”).

• But we do need a credible plan to lower our long-run debt burden.

• We don’t have to kill the recovery – in fact we could spend a bit more in the short-run to bolster employment – but people must be able to see a credible plan for the long-run (but can they believe future commitments from Congress?).
What is the Sequester?

• $1.2 trillion in cuts over 10 years, $85 billion this year. The idea was to put highly unpopular automatic cuts in place to generate a reason to negotiate

• The tactic failed to produce a compromise and the cuts went into effect on March 1

• Split between defense and discretionary spending (not Medicare, Social Security, etc.)

• CBO estimates delays in some cuts will reduce total from $85 billion to $42 billion
Economic Effects of the Sequester

• Macroeconomic Advisers: By the end of 2014, 700,000 jobs (including reductions in armed forces), pushing the civilian unemployment rate up ¼ percentage point. The higher unemployment would linger for several years.
• CBO: It will result in a .6% reduction in economic growth (Fed Chair Bernanke echoed these estimates and urged Congress to take action)
• Mark Zandi of Moody’s Analytics: It will result in a .5% reduction in economic growth
• Cuts are poorly designed (intended to be loathsome to motivate Congress to action)
Inflation

• Because of the large Federal Reserve induced increase in the monetary base in an attempt to stimulate the economy, many people are worried about inflation.

• Some of those people are on the Fed’s monetary policymaking committee (FOMC).

• They remember the turbulent 1970s and are wary of repeating that experience.
The Fed’s Balance Sheet

http://www.econbrowser.com/archives/2013/01/qe3_and_beyond.html
Excess Reserves in Banks

Excess Reserves of Depository Institutions (EXCRESNS)
Source: Board of Governors of the Federal Reserve System

http://research.stlouisfed.org/fred2/series/EXCRESNS?cid=123
Inflation

• But this is a different type of shock than 70s.
• No signs of price pressure yet:
  – inflation is presently a bit below target
  – long-run expectations are stable
• And the Fed has a new tool to fight inflation it didn’t have prior to the Great Recession, the interest it pays on reserves (could even be negative).
PCE Inflation (Less Food and Energy)

http://research.stlouisfed.org/fred2/graph/?chart_type=line&s[1][id]=PCEPILFE&s[1][transformation]=pc1
PCE Inflation

http://research.stlouisfed.org/fred2/graph/?chart_type=line&s[1][id]=PCEPI&s[1][transformation]=pc1
Consequences of Inflation

• But can’t be certain inflation won’t occur (and a little bit during the recovery could even be helpful). So what are the costs if it occurs?
• Note first the short-run stimulative benefits (which are strongest in a weak economy):
  – lowers real debt burden for households
  – More attractive exchange rate
  – Increases inflation expectations and lowers the real interest rate
  – Increases asset values
Consequences of Inflation

But there are costs in the longer-run:

- “Menu costs“ (changing price schedules, etc., though digital technology has reduced these, plus customer dislike of price variability)
- When uneven across goods or unpredictable, it can direct resources to the wrong places (bad price signals in presence of price rigidities, e.g.)
- It makes long-run contracts harder (long-run returns harder to predict if future inflation level is uncertain—variance is important here)
- It can redistribute income in unintentional ways (e.g. borrowers are helped, lenders hurt with fixed interest rate contracts)
Conclusion

• Least worried about inflation. We have the tools to prevent it, and it’s less costly than long-term unemployment if it occurs.
• Most worried about long-term unemployment which is a big, costly problem that doesn’t seem to be going away at anything near an acceptable rate. Infrastructure spending would help.
• The debt is in the middle. I am not worried about the next few years, but in the long-run we do need to get the debt under control. It will take both spending cuts and tax increases to reach this goal.
• We face a tradeoff. Attempts to lower unemployment can increase the risk of inflation (monetary policy) and increase the debt (fiscal policy). The reverse is true as well. Attempts to lower the debt and reduce the risk of inflation can increase unemployment.
• In my view, presently we are too worried about inflation and debt, and not worried enough about unemployment.