





Government
and fiscal stimulus

A story about expectations



Can a government revive a sluggish economy?



2008 recession

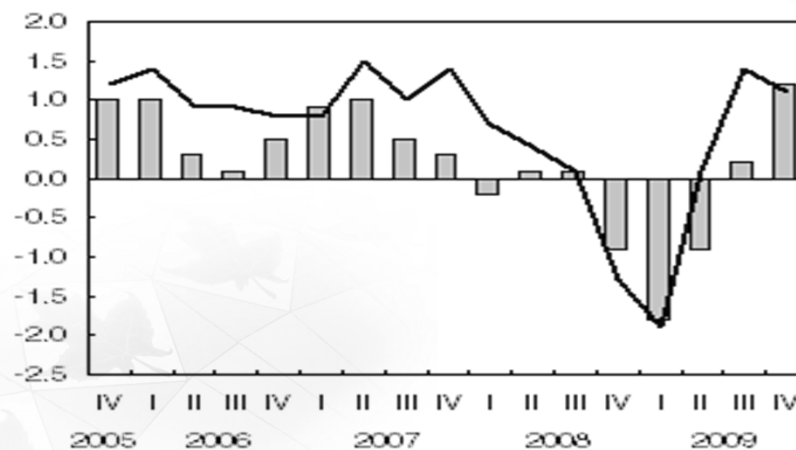
- Negative GDP growth from 2008IV to 2009II.
- The situation was bad all thru 2008.
- Remember:

$$Y = C + I + G + (EX - IM)$$



Final domestic demand advances again

quarterly % change



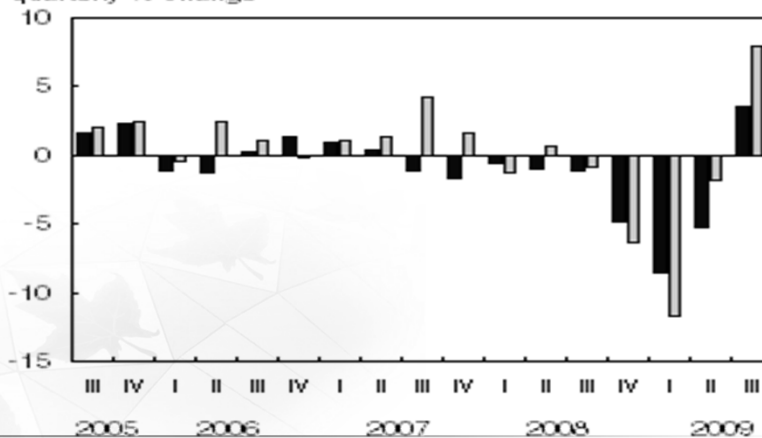
2008 recession

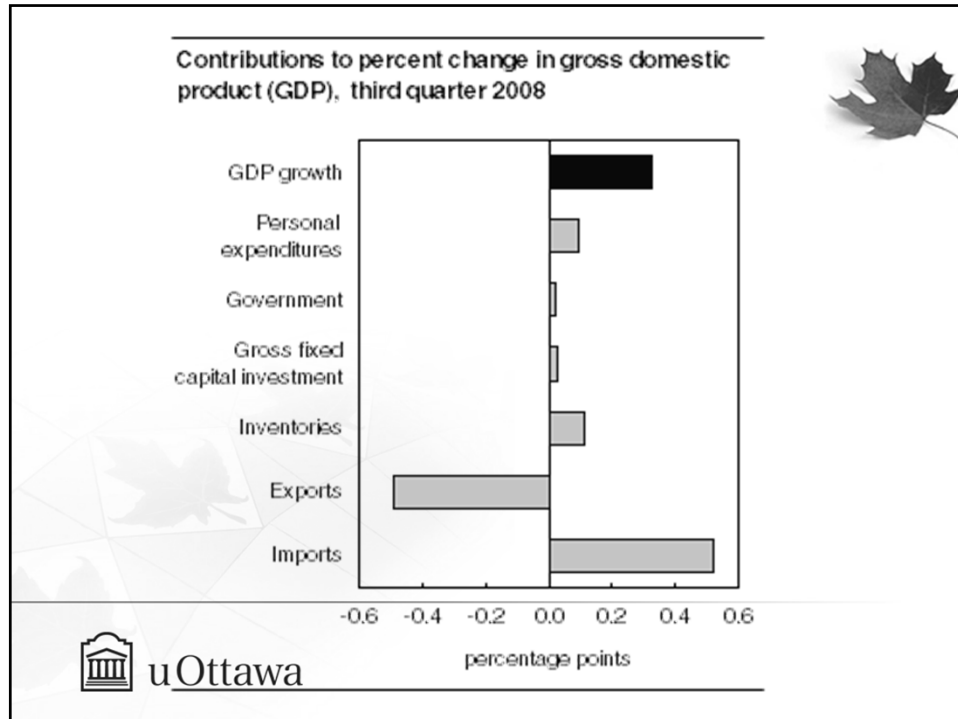
- Sparked in large part by USA recession.
- GDP growth in USA 2008III was already negative.



Exports and imports increase after extended downturn


quarterly % change





Federal gvmt economic update
27 november 2008

- "The federal government is projecting balanced budgets and small surpluses through 2012-13..." (CBC news)
- Flaherty acknowledged that the U.S., Europe and Japan are in recession and that private-sector forecasters expect negative growth in Canada... (CBC news)
- By November 27 2008, the Conservative gvmt had no intention to adopt a stimulus package.
- Conservatives were optimistic:
 - Sound banking sector
 - No housing bubble of the USA-UK sort
- The IMF was by then already recommending concerted action between OECD countries.



Debate



The IMF's position was not universally supported by economists.

Arguments against:

- Theory: Fiscal stimulus is associated with anticipation of increased taxes which leads to lower spending now.
- Evidence: There is little evidence that fiscal stimulus can kick start an economy.
- NB Use of monetary policy was essentially impossible due to already rock bottom interest rates.



Debate



Arguments for:

- Theory: Keynesian view that the government can stimulate an economy. (The same basic model that you have learned in Intermediate Macro I.)
- Evidence: Economists are still struggling with finding evidence that the Keynesian model works. (The multiplier tends to fall between 0.5 and 1.0.)
- Empirical work is notoriously difficult to come by. A "counterfactual" analysis is very difficult.
- So why did the IMF proposed a large concerted action?
- NB IMF usually errs on the conservative side and its own research points to a multiplier smaller than 1.0.



Meanwhile (fourth quarter 2008)

Contributions to percent change in gross domestic product (GDP), fourth quarter 2008



Historical parallel The great depression

A surprisingly very similar parallel can be made with the USA elections of 1932.

(ref: Eggertsson AER 2008 read pp 1476-1483.)



Setting the clock back to 1933



- Depression in the USA began in 1929
 - 1929-1933 GDP declines by 30%
 - 1932 GDP contracts by 13.4%
 - 1932 CPI drops by 10.2%
- Herbert Hoover was president from 1929 to 1933.
- Franklin Delano Roosevelt was elected in November 1932 and inaugurated in March 1933.



Hoover dogmas



1. The gold standard (keep inflation low)
 2. Balanced budget (no debt)
 3. Small government (no public projects)
- Quote from a September 1931 address:

Every additional expenditure placed upon our government in this emergency magnifies itself out of all proportion into intolerable pressures, whether it is by taxation or by loans. Either loans or taxes [...] will increase unemployment. [...] We can carry our present expenditures without jeopardy to national stability. We can carry no more without grave risks.



Hoover dogmas



- Hoover was publicly frantic about balancing budget.
- But deficit increased due to lower revenues from recession (lower tax payments on income in general).
- Citation from Eggertsson (2008): "President Hoover successfully sponsored a massive tax increase in late 1931 to recoup the decline in federal tax revenues. The maximum personal income tax rate rose from 25 to 63 percent. Corporate income taxes rose, estate taxes were doubled, and gift taxes reintroduced (see Temin and Wigmore 1990)."



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Roosevelt dogmas



- During Roosevelt's first year in office:
 1. Abolish gold standard
 2. Nearly doubling of gvm't's consumption and investment financed by deficit
- Main goal: Bring back inflation.
"If we cannot do this one way, we will do it another. Do it, we will." (Roosevelt 1933)
- Those actions were largely unexpected as they were not part of the Democratic platform at election time.



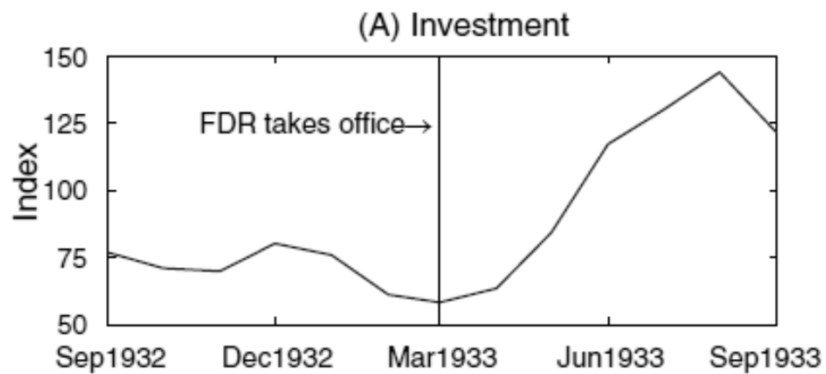
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Roosevelt dogmas

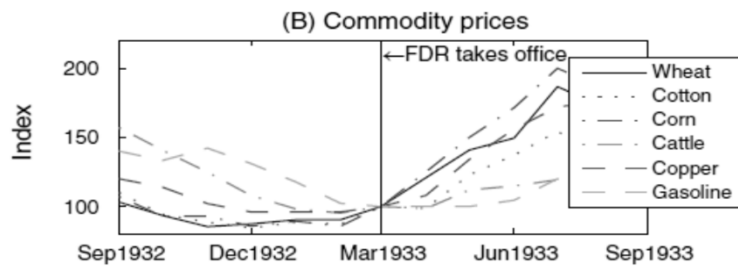
- In short, upon taking office in March 1933, Roosevelt credibly committed to create inflation.
- Expectations shifted from deflationary and contractionary to inflationary and expansionary.
 - Higher expected inflation lowers real interest rates.
 - Higher expected income stimulates demand and investment now (permanent income).
- NB 6 months is too short for large increase in gvmt expenditures.



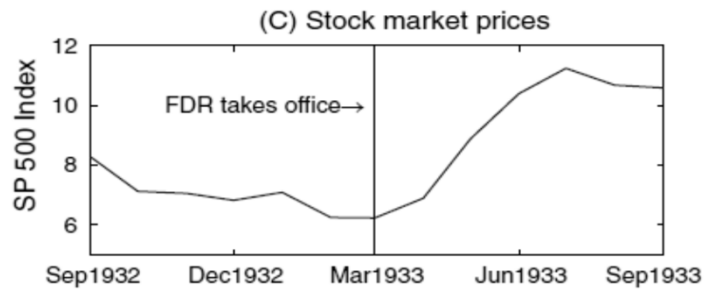
Forward-looking variable (6 months)

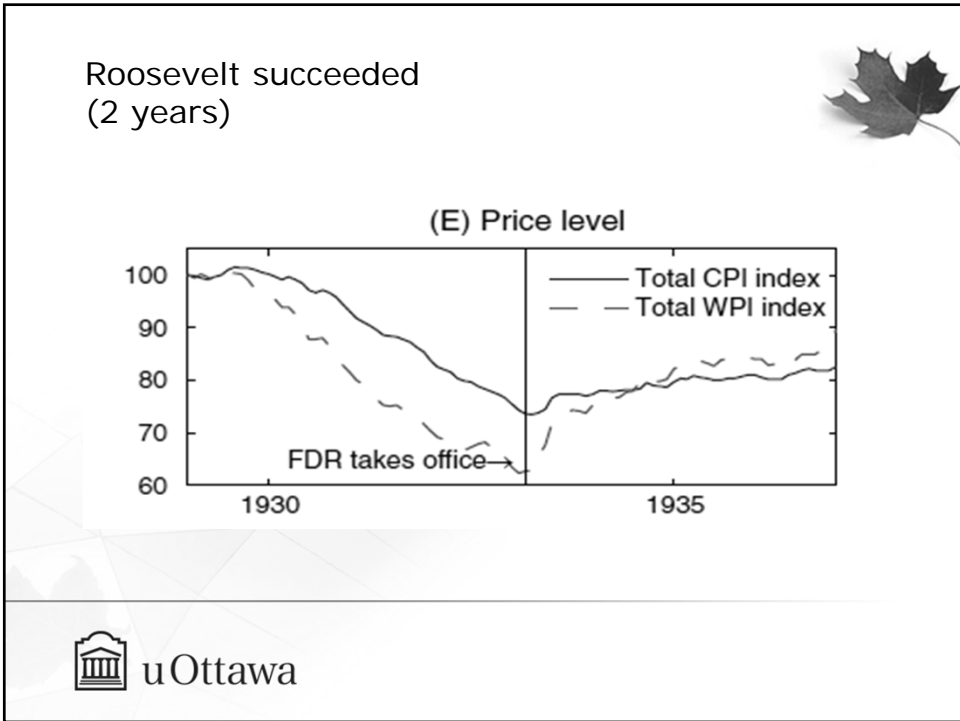
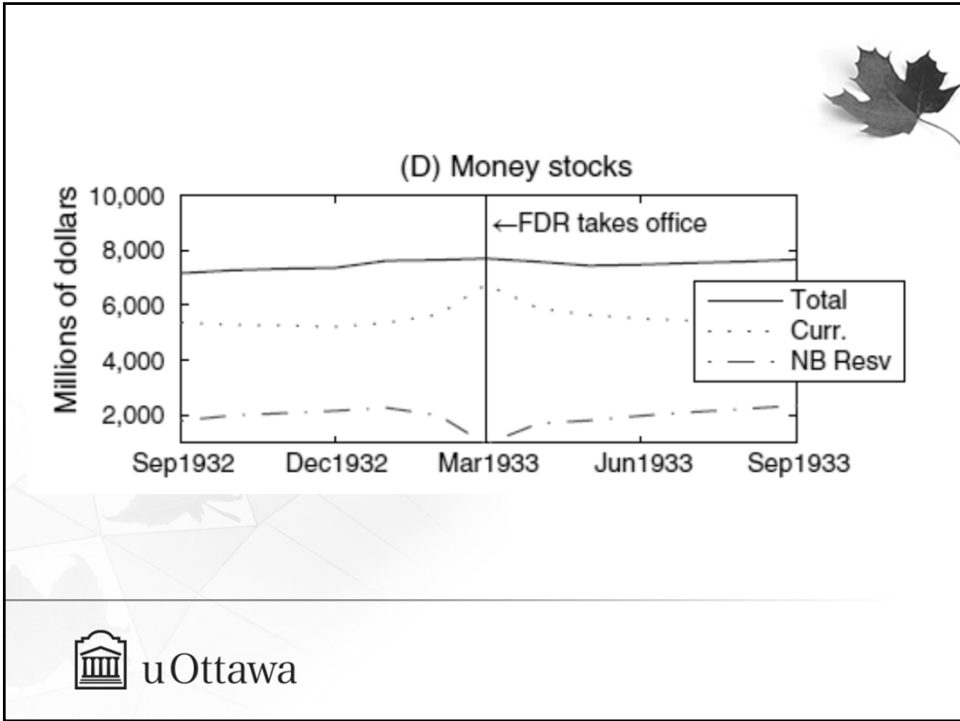


Forward-looking variable
(6 months)

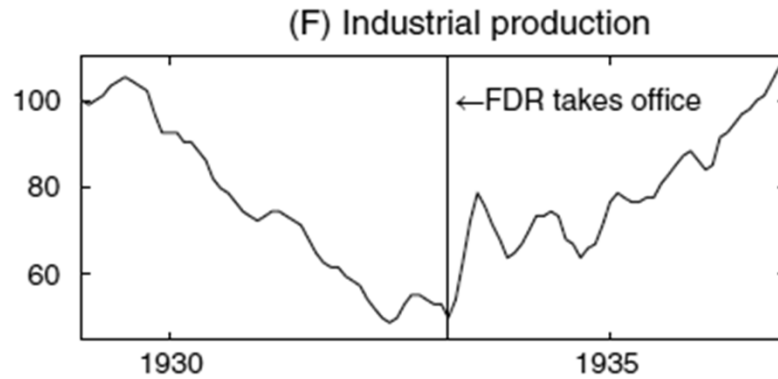


Forward-looking variable
(6 months)





Roosevelt succeeded
(2 years)




Recipe for success (conjecture)



Shift in expectations due to UNanticipated shift in policy.



- Noteworthy:
 - Roosevelt's deficit was deliberate and announced to be so.
 - Hoover was trying to fight the deficit.






Fiscal stimulus and the evidence

The problem of expectations



The problem with empirical work

- If fluctuations are about expectations, trying to link economic growth with contemporary gvmnt expenditures will not work.
- Linking with past gvmnt expenditures is even worse.
- The link must be made with timing of shift in expectations.
- Measuring expectations is hard to do.



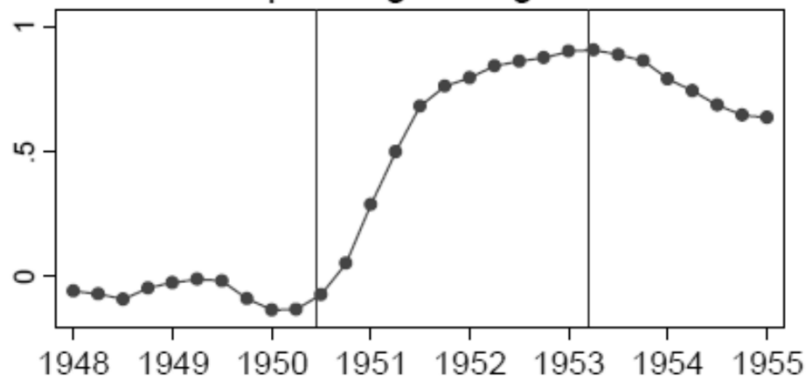
Empirical work

- Valerie Ramey (2009)
- Uses news about forecast gvmnt expenditures instead of actual expenditures.
- Concentrates on USA and military expenditures after WWII.

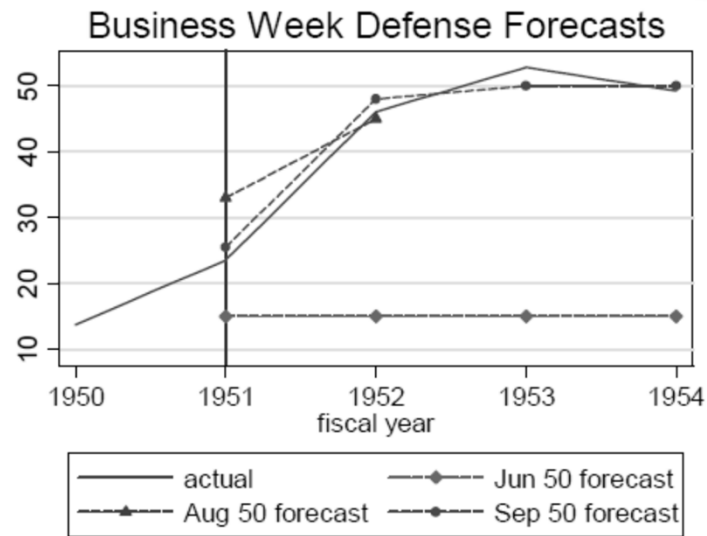


Ramey 2009

Defense Spending During Korean War



Ramey 2009




Ramey 2009

- Ramey argues that business investment rises right after jump in forecast increase in military expenditures.
- Firms build up capital to be ready for government contracts.
- By the time gvmt expenditures are actually made, investment falls down.





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Back to the future

2008-2009 recession



The coalition

- On December 1, 2008, a coalition of opposition parties (Liberals and NDP) threaten to topple minority Conservative gvmt.
- Conservatives ask for a prorogation of parliament.
- A new budget is adopted on 27 January 2009 with important stimulus package corresponding with opposition's demands.



First quarter 2009

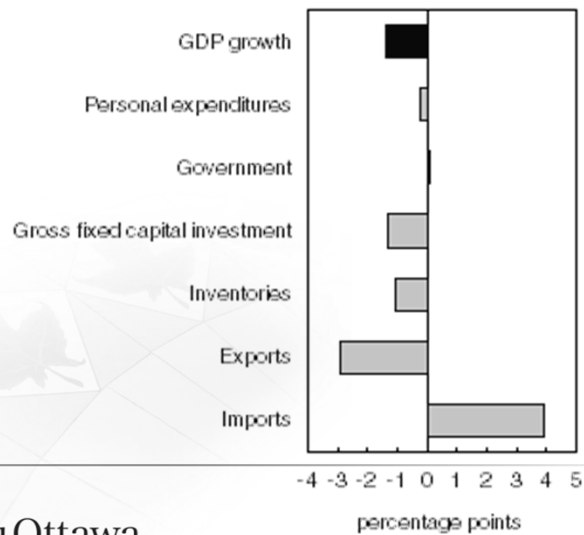
- "The price of goods and services produced in Canada fell 1.7%, following a 2.9% drop in the fourth quarter of 2008." (Statcan 01/06/09)
- NB Persistent deflation is considered really scary news.

- Remember:

$$Y = C + I + G + NX$$

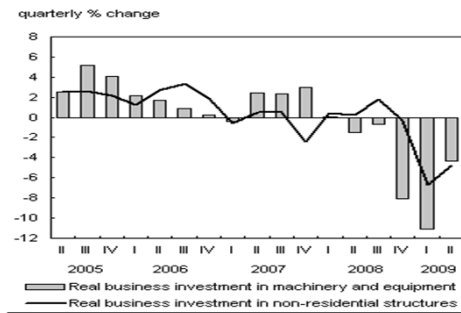


Contributions to percent change in real gross domestic product (GDP), first quarter 2009

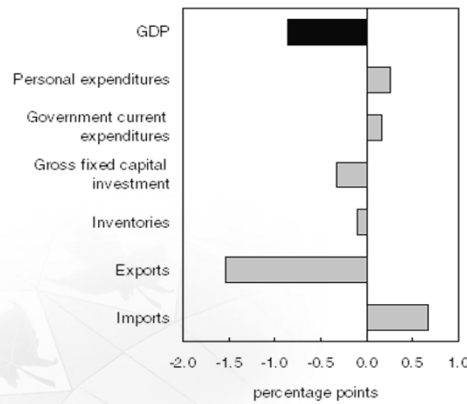


Second quarter 2009

- Negative GDP growth
- Growth in consumption
- Government expenditures growth remains low.
- Investment remains negative
- "The price of goods and services produced in Canada increased 0.3%, after declines in the two previous quarters." (Statcan 31/08/09)



Contributions to percent change in real gross domestic product (GDP), second quarter 2009



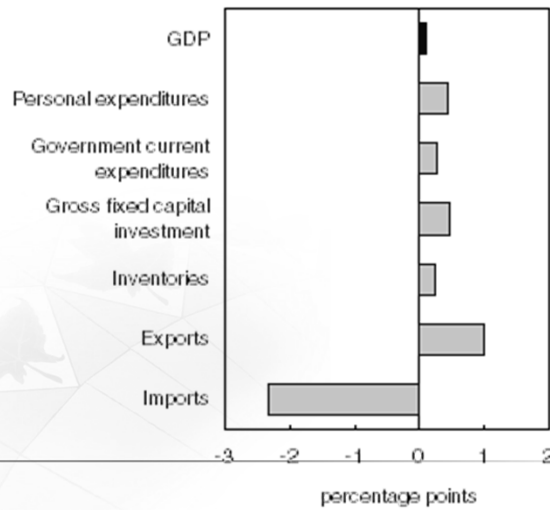
Third quarter 2009



- Investment and consumption contribute importantly to GDP growth.
- “Business investment in machinery and equipment grew 5.9% in the third quarter, following five quarters of decline. Outlays on motor vehicles and industrial machinery led the surge.” (The Daily, 30/11/09, Statcan)
- So do exports. (concerted action?)
- Jump in imports limits GDP growth.



Contributions to percent change in real gross domestic product (GDP), third quarter 2009



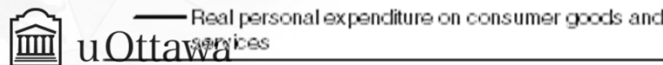
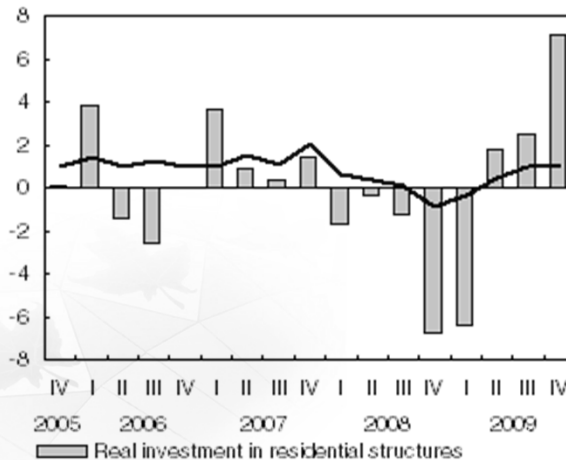
Fourth quarter 2009

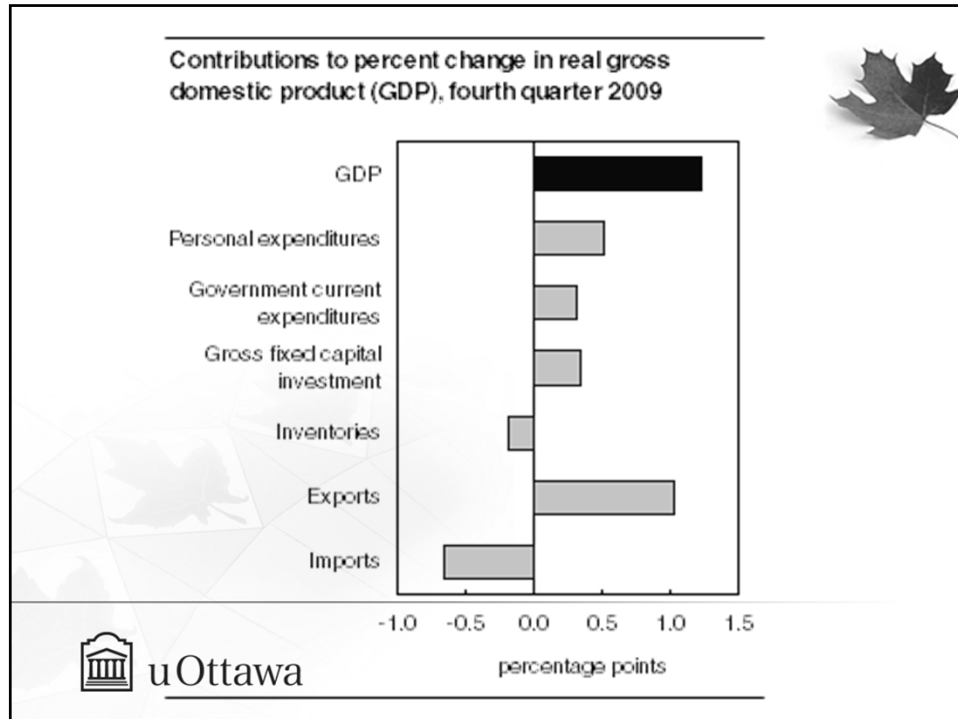
- "Investment in machinery and equipment fell 2.4% after a 5.3% gain the previous quarter." (The Daily, 01/03/10)
- "The price of goods and services produced in Canada advanced 1.1%." (The Daily, 01/03/10)
- "growth in final domestic demand was led by increases in personal expenditures, government expenditures, and investment in residential structures." (The Daily, 01/03/10)



Household demand expands

quarterly % change





Expectations

- Contribution of business investment to GDP growth in the 3rd quarter 2009 looks a lot like the story of 1933.
- Could the prorogation of gvmt and the January 27 2009 budget be akin to an unexpected expansionary policy?
- Investment and consumption jump even though gvmt expenditures have barely begun.
- If so, trying to link end of recession with contemporary (and past) increase in gvmt expenditures is wrong approach.
- Recessions and expansions are forward-looking phenomena.

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Outlook



Back to economic update November 2008

- The Conservatives were right to say that the fundamentals of the Canadian economy were sound.
- Could the announcement of a (precautionary) stimulus package have been interpreted as news that things are not going so well?
- If so, the induced shift in expectations could have actually created a worse recession.
- Dealing with expectations is not an easy matter.