January 13, 2012

Economics Group

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Special Commentary

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How Might Fiscal Restraint Generate Economic Growth?

Recent experiences in fiscal policy in Europe and the United States have highlighted the debate over the effect of fiscal policy on aggregate demand in a traditional model of the macroeconomy. The predominant view, at least prior to recent experiences, was that increased federal spending and/or lower taxes would tend to raise gross domestic product (GDP) in the economy. This is the approach taught to undergraduates in introductory economics courses.

Yet, this view has fallen on hard times as fiscal stimulus in the United States has produced very poor results compared to forecasts, and in Europe, both the size of government and the amount of spending at the central government level appear to have gone beyond the point of positive returns to the economy. From our viewpoint, the fundamental problem is that the framework of the European and U.S. economies evolved from the period of the 1960s to 1980s when fiscal policy appeared to offer some sign of success. Because of the evolution in the structure of the economy, the policy prescriptions of that era have not produced the promised results for growth and jobs in the 21st century.

What are the characteristics of a policy and an economy that would suggest fiscal restraint might actually lead to more rapid economic growth over time?

How then might a move toward fiscal restraint, as measured by reduced federal spending, lead to higher economic growth in the long run? What are the characteristics of a policy and an economy that would suggest a move to fiscal restraint might actually lead to more rapid economic growth over time?

Factors Affecting Fiscal Restraint on Growth

The way in which changes in government spending or taxes will alter economic growth in either direction depends on the assumptions in the underlying model. In recent years, fiscal stimulus appears to have had a muted effect and, measured by employment and GDP growth, has produced much less than promised. Of course, one could argue the counterfactual that we could be much worse off without the recent stimulus, but it would be difficult to prove. In part, the promise of results reflects an overconfidence bias on the part of policymakers. This first surfaced in 1968 with the income surtax and reflects that policymakers typically assume a very positive self-assessment of their ability to manage the economy.

While in the short run fiscal restraint may create a drag on growth, under certain conditions a reduction in federal spending may help facilitate growth over a longer time horizon.

How changes in government spending will alter the path of economic growth will depend on many factors, thereby making it difficult for policies to always achieve their full desired effect. These factors include the nature of the policy; businesses' and households' perception of the policy; the economic resources involved in the change; the availability of credit to finance the plan; the effects of the policy on international trade competitiveness; and the reaction of the monetary authority. While in the short run fiscal restraint may create a drag on growth, under certain conditions a sustainable, credible reduction in federal spending may help facilitate growth through a number of channels over a longer time horizon.[1]

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[1] Alesina, A. and Ardagna, S. (1998) Tales of Fiscal Adjustment. *Economic Policy,* Vol. 13 (27), 487-545. Giavazzi, F. and Pagano, M. (1996) Non-Keynesian Effects of Fiscal Policy Changes: International Evidence and the Swedish Experience. *Swedish Economic Policy Review,* Vol. 3 (1) 67-103.

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The Character of Fiscal Stimulus and Restraint: Time Inconsistency

To have a long-lasting effect on consumer and businesses' behavior, changes in policy must be perceived as permanent.

The effects of fiscal stimulus, or restraint, on economic growth will depend on the characteristics of the fiscal policy. First, what is the duration of the policy? In recent years, fiscal stimulus applied through programs such as the first-time homebuyers' tax credit and cash for clunkers, were temporary and, therefore, did not lead to long-term changes in behavior or economic activity. Instead of turning the housing and auto markets around, these temporary policies merely changed the timing of purchases and may have actually had a negative effect on consumer and business confidence when these programs failed to deliver the intended results (Figures 1 and 2). Similarly, the 2008 tax rebate had little success in boosting economic activity in a meaningful way as the increase in income was a temporary, one-time event. To have a long-lasting effect on consumer and businesses' behavior, changes in policy must be perceived as permanent. [2]

Figure 1

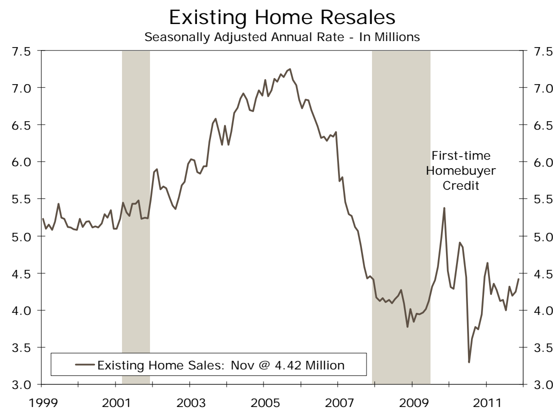
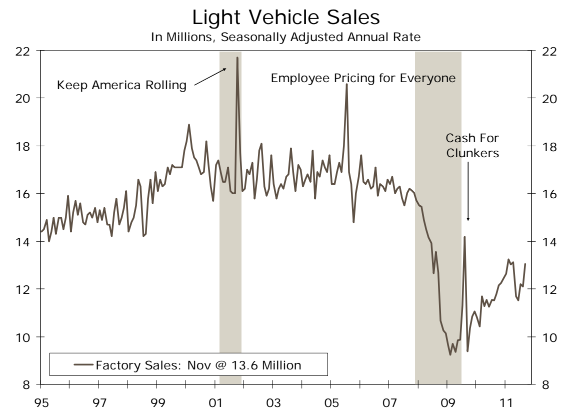


Figure 2



Source: National Association of Realtors, U.S. Department of Commerce and Wells Fargo Securities, LLC

Moreover, do even long-term policies have staying power? Is the pace and allocation of federal spending increases/reductions sustainable over time? For fiscal policy to make a difference, the pace and allocation of federal spending increases or decreases must be viable over time. This was certainly true in the case of Canada's fiscal tightening in the 1994–1995 period. As a counterpoint, the increased public spending in Europe amid anemic economic growth has led to outsized fiscal deficits that do not seem to be sustainable and, therefore, did not generate expectations of a sustained fiscal policy going forward. The same might be said of the U.S. attempt of fiscal stimulus in 2009. Political time horizons of two or four years are inconsistent with long-run decision making.

Sustainability is not simply a political story but also a financial story.

Sustainability is not simply a political story but also a financial story. For any country, will increasing spending generate a rise in debt finance, and thereby interest rates, to a level in excess of nominal GDP growth—the ability of the economy to pay that debt? This balancing act between nominal GDP growth and interest rates reflects the principle that federal spending growth, and the debt that is associated with it, is sustainable as long as the growth of the economy is strong enough to pay the interest expense on the outstanding debt. Yet, is sustained fiscal discipline the culture of politics in America today? Will the growth of entitlement spending outpace growth in the economy, the means to pay for these expenditures in the future?

Confidence and the Multiplier

Underlying all estimates of the impact of fiscal policy is the assumption that aggregate demand will increase through a multiplier process. The assumption of a multiplier is based on the belief that consumers and businesses are willing to spend income as it is received, thereby generating income for others going forward. Similarly, it assumes businesses are willing to spend tax breaks

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[2] **Hellwig, M. and Neumann, M. (1987). Economic Policy in Germany: Was There a Turnaround? *Economic Policy* 5 (October): 105-40.**

on investment and new jobs in the United States. This assumption holds whether policy is channeled through tax breaks or through direct government spending.

Yet, in recent years, the multiplier appears to have fallen short of expectations as the goals for output and employment have been more difficult to achieve. For the consumer, two changing behaviors were clearly in the way of fulfilling the multiplier process. First, confidence in the economy and the job market has been extremely low since the past recession began, and therefore when consumers received income, they were less likely to spend along the lines of prior recoveries, reducing the multiplier effects of an increase in income. Indeed, the saving rate in the 12 months following the end of the past recession averaged 4.8 percent compared to 3.5 percent following the 2001 recession. Optimism about the economy after the onset of the past recession was also extremely low for businesses, making them less likely to purchase new equipment or hire more workers (Figure 3). Second, when consumers did receive income, instead of spending that income as they had in prior recoveries, they had a strong desire to pay down debt. This reduced the amount of income being recycled back into the spending stream, as evidenced by the sharp drop in household debt relative to income in Figure 4, and also reduced the multiplier.

Figure 3

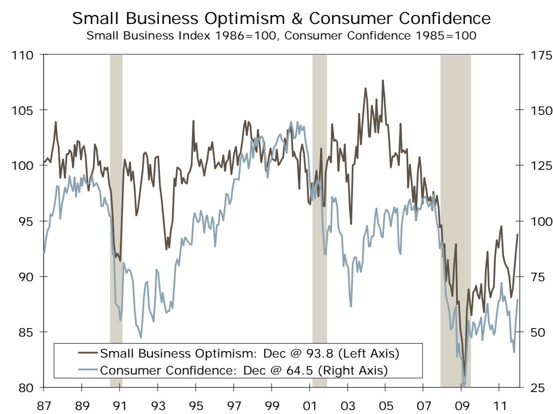
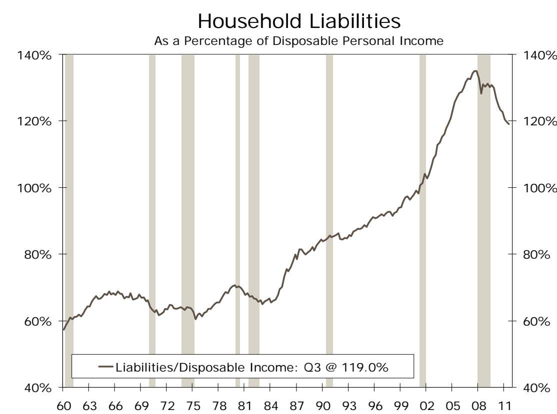


Figure 4



Source: The Conference Board, NFIB, Federal Reserve Board and Wells Fargo Securities, LLC

Resources of Production in the Public or Private Sector

If public sector productivity is below private sector productivity, the transfer of those resources to the private sector would actually increase output in the economy.

Another aspect of federal spending is that too large a government sector may exert a claim on too many productive resources such that the marginal productivity of those resources falls below the optimal level. If public sector productivity is below private sector productivity for certain resources and federal spending were cut, the transfer of those resources to the private sector would actually increase output in the economy. Yet, in an environment of fiscal austerity, will private sector spending rise and take advantage of newly available resources, thereby sustaining growth in the short run?

In the early post-WWII era, decreased government production opened up resources, such as rubber and steel for autos and lumber and copper for housing construction. As a result, reductions in federal spending were met with increases in private production. Cutbacks in public production opened up opportunities for private companies to develop in the aircraft, aluminum and steel industries, for example.[3] Would fiscal restraint today, when the government is more geared toward providing services, lead to an increase in private production as quickly or significantly as it did in the post-WWII era?

[3] **Fels, G. and Froelich, H. (1986). Germany and the World Economy: A German View. *Economic Policy* 4 (April) 178-195.**

How the Federal Government Pays the Bills

Three options are available for paying the bills: taxes, bonds and printing money—that is direct financing of government deficits by the central bank. Taxes alter the expected rate of return on work, saving and investment and, as such, alter the pattern of production and resource allocation in a society. Issuing bonds alters the supply of debt and, thereby, alters market interest rates. If debt issuance is perceived as excessive, this could lead to a rapid rise in interest rates with little buyer interest and a failed auction. Finally, the federal government, through its central bank, could always print money in the grand tradition of Louis XIV or, more recently, Zimbabwe.

Increasing federal spending has been shown to provide less stimulus to the overall economy than a reduction in taxes, according to some of the literature on fiscal policy.[4] However, what about the possibility of reduced spending and reduced future taxes? The tax reduction does offer at least a partial offset to the fiscal drag in the short run as consumers and businesses now have more money to spend, assuming they do spend it at the anticipated rate. In the long run, the expected reduction of future taxes must be credible, and the cuts in spending must be persistent.[5] In like manner, reduced bond issuance would lower market interest rates, while a reduction in money growth would reduce inflation fears and, therefore, lower interest rates over the long run. As a result, how the federal government would finance a reduction in spending could offer at least a partial offset to any fiscal drag in the short run and could be expansionary in the long run if fiscal restraint is viewed as credible and long-term rates fall significantly over time. However, in today's environment, how much lower can interest rates fall?

The Credit Linkage

The state of the credit market and the market's perception of fiscal policy will greatly influence the effectiveness of that policy. This linkage is possibly one of the most significant changes in the U.S. economy since WWII. In the early post-WWII period, the build-up of low interest savings in the United States from the war period afforded fiscal policymakers a cheap source to finance deficits. Credit was plentiful and its price very low.

Figure 5

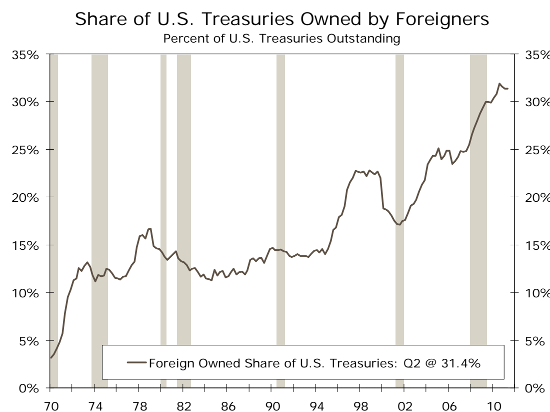
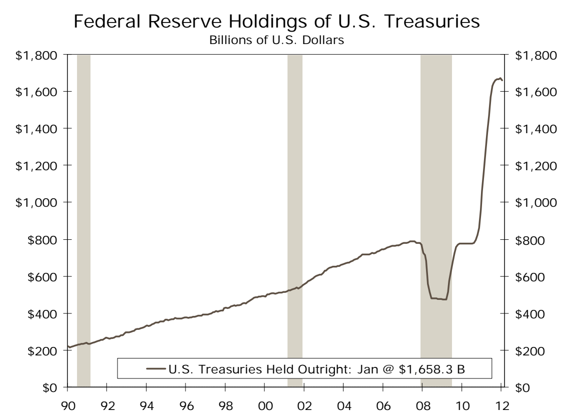


Figure 6



Source: U.S. Department of the Treasury, Federal Reserve Board and Wells Fargo Securities, LLC

Today the availability of credit to finance spending increases is more limited.

Today, the availability of credit to finance spending increases is more limited. In Japan, large fiscal deficits have been financed internally. In contrast, large U.S. federal deficits have been financed by a significant amount of foreign buying, the incentives for which are very different than that assumed in a classical loanable funds model (Figure 5). Three large buyers of U.S. debt today—the Federal Reserve, the central bank of China and the Bank of Japan—are not motivated

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[4] **See, for example, Alesina, A. and Ardagna, S. (2009) Large Changes in Fiscal Policy: Taxes Versus Spending. Working Paper 15438.**

[5] **Barro, R. 1979. On the Determination of Public Debt. *Journal of Political Economy* 87 (5) 940-71. Feldstein, M. (1982) Government Deficits and Aggregate Demand. *Journal of Monetary Economics* 9 (1) 1-20.**

by a goal of maximizing returns for a given risk; these are not mark-to-market buyers (Figure 6). Instead, the Fed is aimed at flattening the yield curve and foreign central banks are in the game of stabilizing their exchange rate relative to the U.S. dollar.

How might credit markets respond to a policy of more fiscal restraint? The response of the financial markets depends on the credibility of the deficit reduction itself. A long-term, credible program may have two significant outcomes and could stimulate spending in the economy in two major ways. In the first possible outcome, deficit reduction reduces the demand for credit in the marketplace and, thereby, raises private investment spending through a decline in long-term real interest rates. In addition, long-term interest rates may adjust downward in expectation of lower future inflation that may reflect fears of debt monetization in the future.

The response of the financial markets depends on the credibility of the deficit reduction itself.

For the second potential outcome, credit markets are forward looking and, therefore, could respond quickly to a serious program of deficit reduction, and that could accelerate the decline in real interest rates, bringing forward the investment dividend associated with balancing the deficit. The initial response to the Italian fiscal program announced in early December 2011 was encouraging, although market uncertainty over a more immediate solution to the European sovereign debt crisis has since pushed Italian government bond yields higher. This again shows that any reduced federal spending program must be credible. A shrinking federal deficit directly lowers real interest rates through a portfolio channel; reduced government borrowing lowers the supply of government bonds relative to other assets and, thereby, would put a downward spin on interest rates as we witnessed in the United States in the 1990s. That said, with yields on today's U.S. Treasury securities near historic lows and longer-term inflation expectations in check, a reduction in debt issuance may have little effect on interest rates and investment in the near term, although rates may be lowered from what they would have been otherwise (Figures 7 and 8).

Figure 7

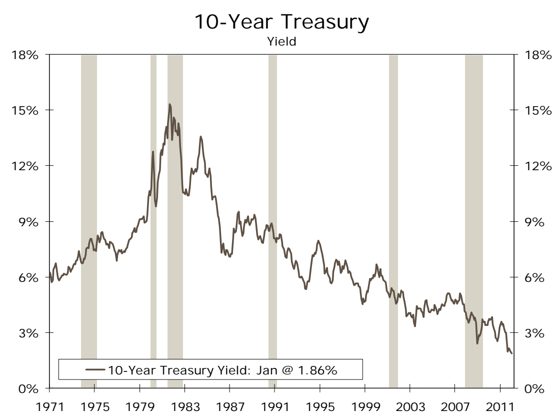
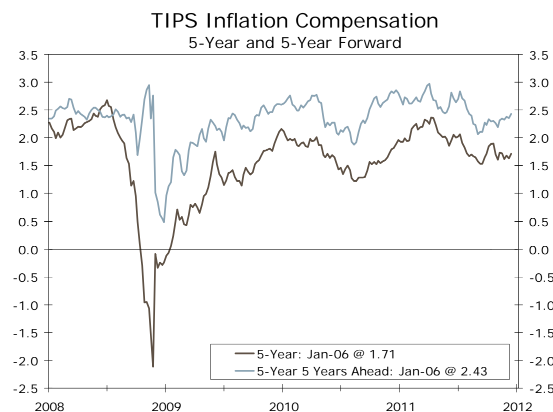


Figure 8



Source: Federal Reserve Board, Bloomberg LP and Wells Fargo Securities, LLC

As mentioned previously, any fiscal policy plan's effectiveness would depend on its credibility, and given that a large source of credit comes from foreign investors, the reaction of foreign investors would play a major role. Over the past two years, the comfort threshold of federal spending has taken a sharp turn toward the downside as European sovereign debt issues and the expected entitlement burdens in the United States intimate at financing strains. There is a significant oversupply of public debt today and more on the way down the road. Even a king as powerful as Louis XIV paid the highest interest rates in Europe due to his extravagant spending.

Today, the perception is that financing U.S. federal debt is simply not sustainable over time. If so, then further fiscal stimulus is unlikely to be effective and, therefore, we are left with only one option: fiscal restraint. Would a policy of fiscal restraint tend to increase real economic growth, in contrast to the fears of economic weakness that dominate the conventional view? The answer would again depend on the size of the interest rate response in the marketplace to fiscal restraint.

If interest rates fall and households and private investors increase their spending, then at least there will be some positive pickup in the economy due to a credible program of fiscal restraint.

Even under a credible plan, fiscal restraint is likely to be painful in the short run.

Even under a credible plan, fiscal restraint is likely to be painful in the short run. In the United Kingdom, fiscal austerity has helped to bring the spread between U.K. 10-Year Gilts and German 10-Year Bunds lower by approximately 90 bps, but two years into the government's austerity program, the country is on the brink of recession. GDP in the United Kingdom increased 0.5 percent on a year-ago basis in the third quarter and is expected to increase only modestly over the course of 2012.[6] In addition to slower growth in government consumption, part of the recent slowdown in GDP growth has stemmed from shocks over the past year, including severe weather last winter and unrest in the Middle East that pushed commodity prices higher; additional headwinds have stemmed from economic weakness and turmoil in financial markets due to the sovereign debt crisis. However, government consumption is expected to be a drag on GDP growth over the next five years.[7] As the government's austerity plan continues to move forward, it leaves little room for the economy to absorb any potential shocks over the next year—a danger at any point when fiscal austerity is undertaken.

Fiscal Restraint and International Trade Competiveness

In a global economy, fiscal restraint would generate some, at least partial, offsetting effects in the medium term.

Initially, a reduction in federal spending would reduce aggregate demand and yet, in a global economy, such a move would generate some, at least partial, offsetting effects in the medium term through an improvement in the current account balance and economic growth. In an economy such as the United States, a restrictive fiscal policy would lead to a short-run reduction in aggregate demand—the effect frequently cited by critics of fiscal policy restraint. Yet, fiscal restraint should also lead to lower interest rates as the risk for debt repayment falls. Lower interest rates would increase capital outflows from the economy and, thereby, increase the flow of dollars into the market for foreign exchange. The value of the dollar in the market place would decline, increasing net exports and partially offsetting the decline in federal spending. This certainly was true of the Canadian austerity experience in the mid-1990s (Figure 9).[8] Lower interest rates may also stimulate additional investment spending (Figure 10), although this effect would be muted given current interest rate levels, as we have discussed earlier.

Figure 9

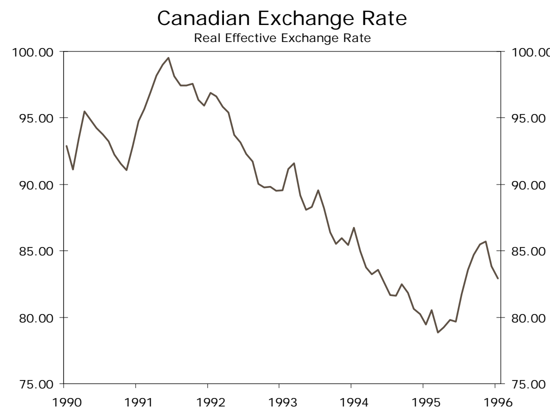
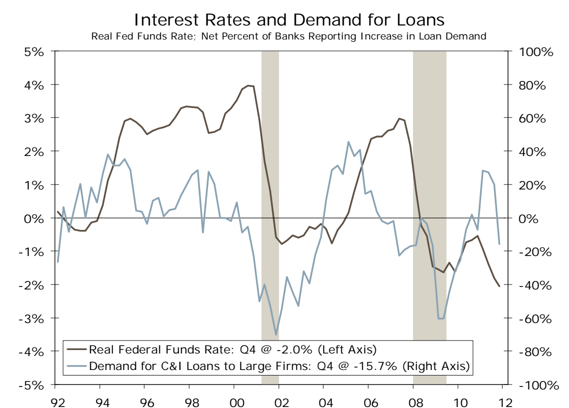


Figure 10



Source: IHS Global Insight, Federal Reserve Board, U.S. Dept. of Labor and Wells Fargo Securities, LLC

The Monetary Policy Channel

How might monetary policy react to a cut in federal spending? In the short run, an easing of monetary policy may help to offset the initial drag of reduced federal spending as the effects on

[6] We forecast GDP in the United Kingdom to increase 0.9 percent in 2012.
[7] Office for Budget Responsibility "Economic and Fiscal Outlook," November 2011.
[8] See "Would Canadian-Style Budget Cutting Work in America" (October 26, 2010), which is available on request.

credit availability and the dollar's exchange rate work through the system. Looking further ahead, a more restrictive fiscal policy relative to the current path of spending diminishes the likelihood that monetary policy in the future may have to restrain an overheating economy. As a result, expectations of future interest rates should move lower and flatten the yield curve relative to its current position. This would help to stimulate investment spending and to keep mortgage rates low, boosting economic growth as an offset to the initial cut in fiscal spending. This response by the Fed would hold especially if the Fed is targeting economic growth and income, the current position, as opposed to targeting the money supply or interest rates, which were policy positions in the past.

Would Fiscal Restraint Boost Growth in the United States?

The underwhelming effect of recent stimulus measures and the growing debt levels of many developed countries have highlighted the question of whether fiscal restraint, as opposed to fiscal stimulus, may be better able to spur economic growth in the long run. In the short run, fiscal restraint would likely lead to a reduction in aggregate demand. Monetary policy easing may help to limit the initial decline in growth, as might a favorable investor reaction to the plan which would also lower interest rates. However, as seen in the United Kingdom today, fiscal austerity can yield tepid, and potentially negative, growth in the short run.

Over a longer period, there are channels that could at least partially offset the drag of a reduction in government spending, making fiscal restraint less severe than what is often thought.[9] Given a credible and sustainable plan, fiscal restraint would likely reduce the costs of borrowing, thereby lowering long-term interest rates and raising the amount of private sector investment. It may also help improve trade competiveness as lower interest rates would likely lead to an increase in capital outflows and a depreciation of the dollar, providing a boost to net exports. In addition, a reduction in federal spending would free up resources in the economy that may be more efficiently used in the private sector. Finally, monetary policy may have less need to undertake tightening measures in the future to reign in an economy over-fueled by credit borrowing.

Over a longer period, there are channels that could at least partially offset the drag of a reduction in federal spending, making fiscal restraint less severe than what is often thought.

That said, today's economic environment poses several challenges for potential benefits of fiscal restraint to take hold in the United States. Monetary policy is already exceptionally accommodative, with the Federal Funds target rate held near zero for over the past three years, the Fed balance sheet at record-high levels and open market operations specifically aimed at lowering the long end of the yield curve. As such, the channels by which fiscal austerity that can generate lower interest rates, and therefore greater investment, are likely to be less effective than they have been in the past given that both short-term and long-term interest rates are already near historic lows. Furthermore, although the pace is slowing, consumer deleveraging is likely not yet behind us. As consumers continue to repair their balance sheets to improve their credit position, they may be relatively more reluctant to spend an increase in income stemming from tax reductions than they were before the most recent recession. This would likely hamper personal consumption spending and provide less of an offset to the drag caused by lower government spending.

It remains to be seen what the effects of fiscal restraint may have on economic growth in the United States. In a dynamic economy with many moving parts, the success of fiscal stimulus or restraint is dependant on many factors. Under the conditions we have described, fiscal restraint may not be as harmful as critics often cite given that there would be some partial offsets to growth stemming from a plan of fiscal austerity. However, these channels are likely less effective today in the United States than they have been in the past. Moreover, it remains a question whether any fiscal restraint effort, or any long-term federal program that calls for restraint, can sustain the short-term forces of two- and four-year election cycles. The problem of fiscal restraint is likely more political than economic.

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[9] Giavazzi, F. and Pagano, M. (1990) Can Severe Fiscal Contractions Be Expansionary? Tales of Two Small European Countries. *NBER Macroeconomics Annual 1990.*

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