

ECON 1150 Notes on Debt and Growth:

David Wessel, WSJ **The Californization of Washington**

March 4th,

Updated March 4, 2010 12:01 a.m. ET

California's economy is large, rich and vibrant. It accounts for more than \$1 of every \$7 of goods and services produced in the U.S. and is bigger than all but seven countries. California has less taxpayer-backed state debt per person than Massachusetts and less as a percentage of its economy than New York, according to rating agency Standard & Poor's.

By
DAVID WESSEL



By such measures, California, though hit hard by the recession and housing bust, would seem an unlikely candidate for a government that might not pay its debts. But it is, the result of a dysfunctional political system that combines well-financed referendums, super-majorities in the legislature and politicians unable to grapple with fundamental issues. Talk, now fading, is that only a constitutional convention can fix things.

The future, it's often said, arrives in California first. Is Washington next? The stalemate over health-care legislation, despite widespread acknowledgment that the status quo is unsustainable, underscores the inability of the political system to cope with complex, long-term fiscal issues. Call it the Californization of America.

Today's big budget deficit is not the problem. It is swollen by following the textbook prescription in a deep recession in which the Federal Reserve has cut interest rates to zero. The government-borrowing surge has been matched by a decline in private borrowing.

<http://online.wsj.com/news/articles/SB10001424052748704541304575099371249822654>

[Steven Colbert, 2013 Austerities Spreadsheet Error](#)

<http://www.colbertnation.com/the-colbert-report-videos/425748/april-23-2013/austerity-s-spreadsheet-error>

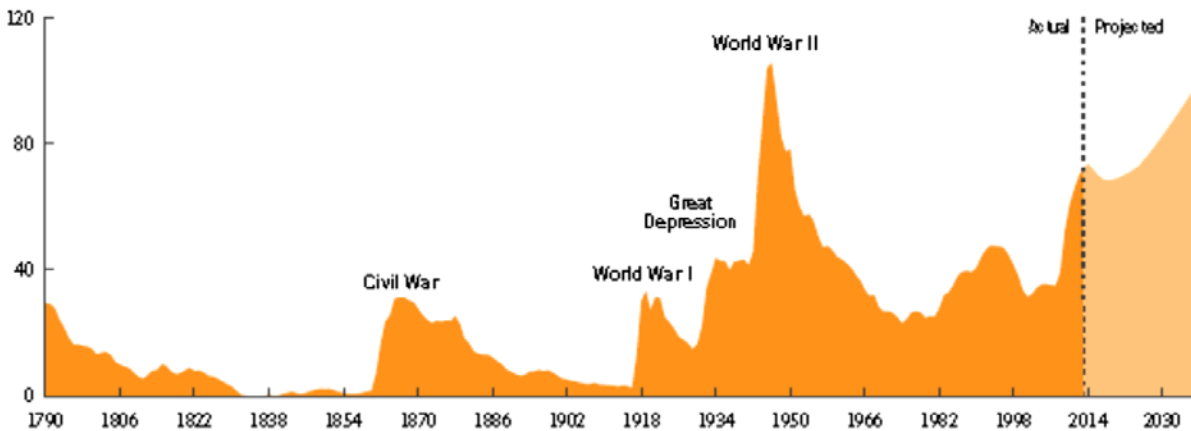
[Rheinart and Rogoff respond to Herndon and Krugman](#)

http://www.nytimes.com/2013/04/26/opinion/reinhart-and-rogoff-responding-to-our-critics.html?smid=pl-share&_r=0

Figure 1-1.

[Return to Reference 1, 2](#)**Federal Debt Held by the Public Under CBO's Extended Baseline**

(Percentage of gross domestic product)



Source: Congressional Budget Office. For details about the sources of data used for past debt held by the public, see Congressional Budget Office, *Historical Data on Federal Debt Held by the Public* (July 2010), www.cbo.gov/publication/21728.

Notes: The extended baseline generally adheres closely to current law, following CBO's 10-year baseline budget projections through 2023 and then extending the baseline concept for the rest of the long-term projection period. The long-term projections of debt do not reflect the economic effects of the policies underlying the extended baseline. (For an analysis of those effects and their impact on debt, see [Chapter 6](#).)

Data from 1929 onward reflect recent revisions by the Bureau of Economic Analysis to estimates of gross domestic product (GDP) in past years and CBO's extrapolation of those revisions to projected future GDP.

Steven Colbert, 2013 Austerities Spreadsheet Error

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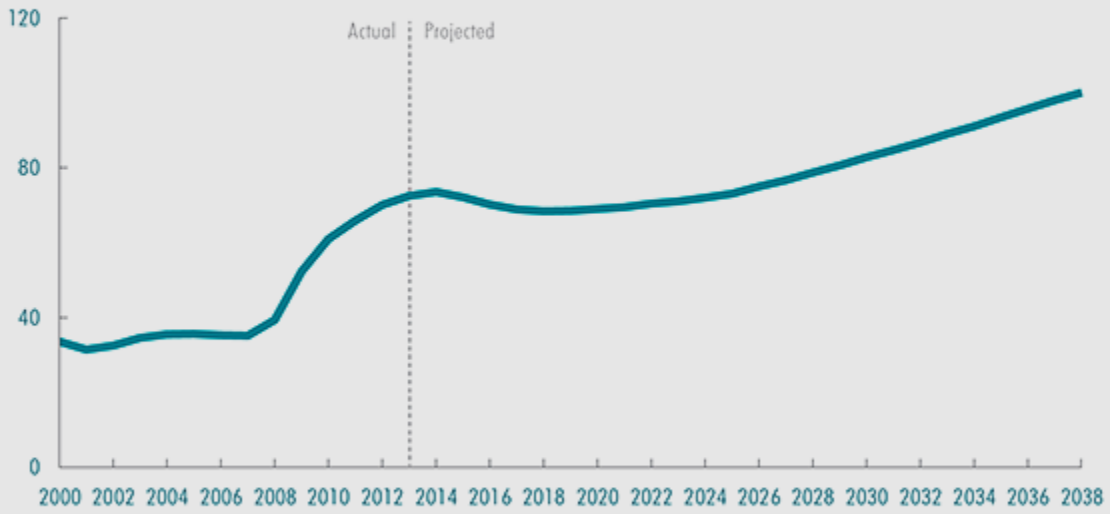
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Federal Debt Held by the Public Under CBO's Extended Baseline

Percentage of GDP



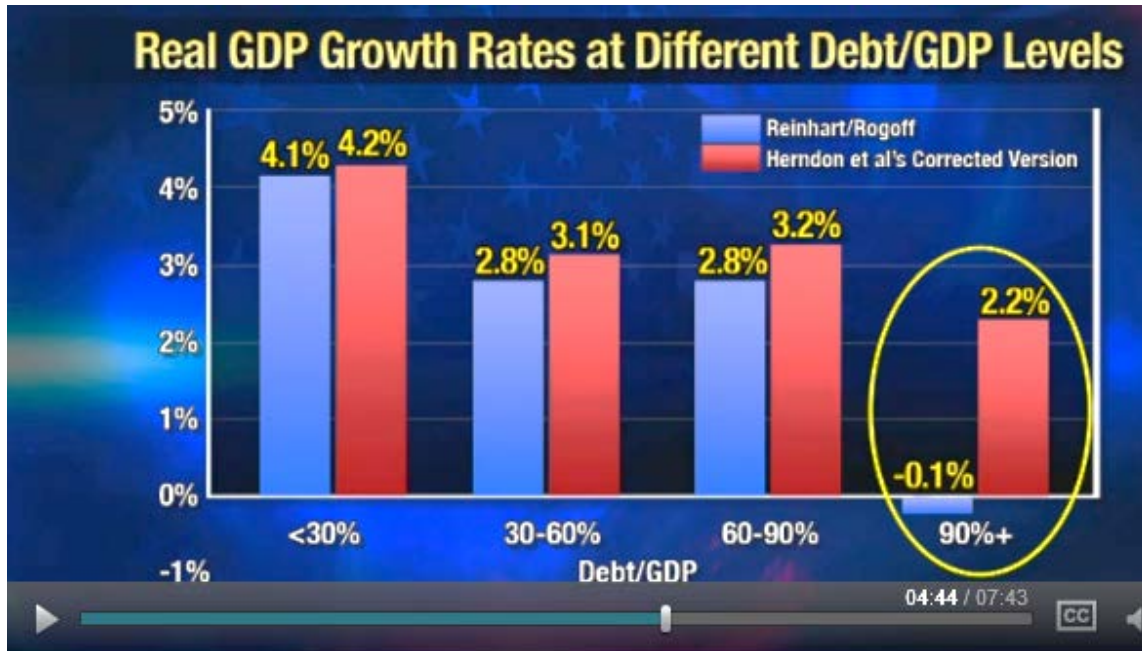
Why Does the Aggregate-Demand Curve Slope Downward?

- 1. The Wealth Effect:** A lower price level increases real wealth, which stimulates spending on consumption.
- 2. The Interest-Rate Effect:** A lower price level reduces the interest rate, which stimulates spending on investment.
- 3. The Exchange-Rate Effect:** A lower price level causes the real exchange rate to depreciate, which stimulates spending on net exports.

Why does the Aggregate-Demand Curve Shift?

- 1. Shifts Arising from Changes in Consumption:** An event that makes consumers spend more at a given price level (a tax cut, a stock-market boom) shifts the aggregate-demand curve to the right. An event that makes consumers spend less at a given price level (a tax hike, a stockmarket decline) shifts the aggregate-demand curve to the left. New Iphone models....
- 2. Shifts Arising from Changes in Investment: “Animal Spirits”** or some event that makes firms invest more at a given price level (optimism about the future, a fall in interest rates due to an increase in the money supply). shifts the aggregate-demand curve to the right. An event that makes firms invest less at a given price level (pessimism about the future, a rise in interest rates due to a decrease in the money supply) shifts the aggregate-demand curve to the left. Examples? Fracking?
- 3. Shifts Arising from Changes in Government Purchases:** (Simulus, the multiplier) An increase in government purchases of goods and services (greater spending on defense or highway construction) shifts the aggregate-demand curve to the right. A decrease in government purchases on goods and services (a cutback in defense or highway spending) shifts the aggregate-demand curve to the left.
- 4. Shifts Arising from Changes in Net Exports:** An event that raises spending on net exports at a given price level (a boom overseas, speculation that causes an exchange-rate depreciation) shifts the aggregate-demand curve to the right. An event that reduces spending on net exports at a given price level (a recession overseas, speculation that causes an exchange-rate appreciation) shifts the aggregate-demand curve to the left. Example right now: Growth in China.

Mankiw (2013-02-01). Principles of Macroeconomics (Page 435). South-Western. Kindle.



Tuesday April 23, 2013 | Views: 290,019 | Comments: 4

Austerity's Spreadsheet Error

Carmen Reinhart and Kenneth Rogoff's 2010 debt study inspires austerity around the world, but grad student Thomas Herndon debunks the results. (07:43)

According to Taylor's original version of the rule, the nominal interest rate should respond to divergences of actual inflation rates from *target* inflation rates and of actual [Gross Domestic Product](#) (GDP) from *potential* GDP:

$$\dot{i}_t = \pi_t + r_t^* + a_\pi(\pi_t - \pi_t^*) + a_y(y_t - \bar{y}_t).$$

In this equation, \dot{i}_t is the target short-term [nominal interest rate](#) (e.g. the [federal funds rate](#) in the US), π_t is the rate of [inflation](#) as measured by the [GDP deflator](#), π_t^* is the desired rate of inflation, r_t^* is the assumed equilibrium real interest rate, y_t is the logarithm of real [GDP](#), and \bar{y}_t is the logarithm of [potential output](#), as determined by a linear trend.

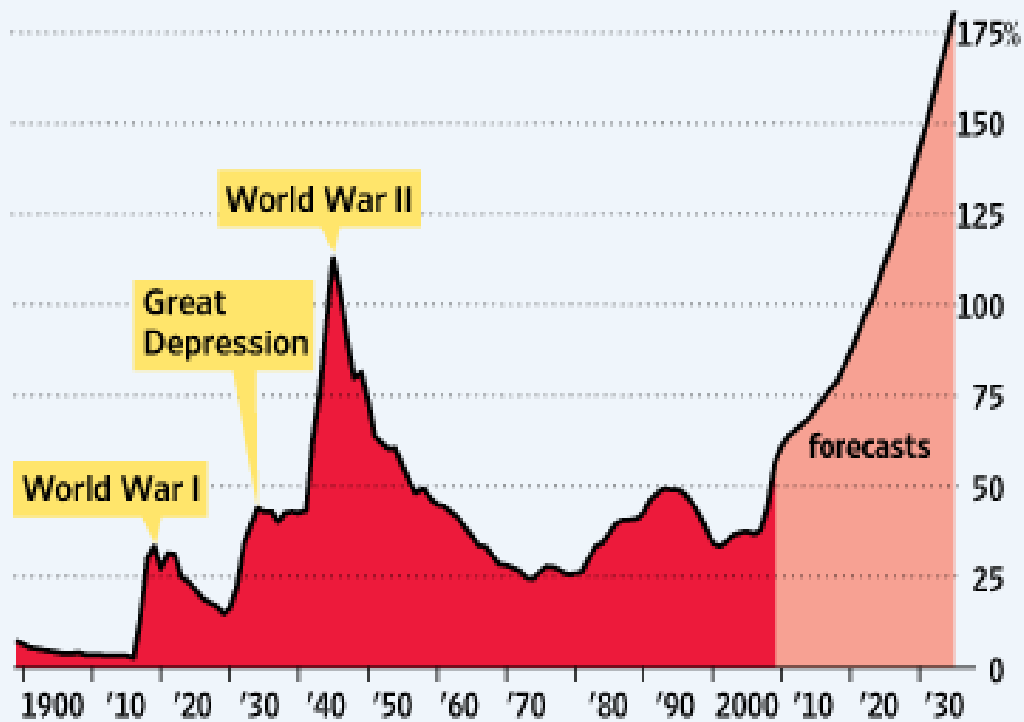
In this equation, both a_π and a_y should be positive (as a rough rule of thumb, Taylor's 1993 paper proposed setting $a_\pi = a_y = 0.5$).^[4] That is, the rule "recommends" a relatively high interest rate (a "tight" monetary policy) when inflation is above its target or when output is above its [full-employment](#) level, in order to reduce inflationary pressure. It recommends a relatively low interest rate ("easy" monetary policy) in the opposite situation, to stimulate output. Sometimes monetary policy goals may conflict, as in the case of [stagflation](#), when inflation is above its target while output is below full employment. In such a situation, a Taylor rule specifies the relative weights given to reducing inflation versus increasing output

$$\dot{i}_t = \pi_t + r_t^* + a_\pi(\pi_t - \pi_t^*) + a_y(y_t - \bar{y}_t).$$

David Wessel (2010) "[The Californization of Washington](http://online.wsj.com/news/articles/SB10001424052748704541304575099371249822654)" March 4th, 2010, *Wall Street Journal online*
<http://online.wsj.com/news/articles/SB10001424052748704541304575099371249822654>

Headed for Trouble

U.S. government debt, measured against gross domestic product.



Note: Assumes current policies and some policy changes widely expected to occur, including extension of Bush tax cuts and appropriated spending growing at same pace as economy.

Source: Congressional Budget Office

Most recent CBO projections

