Ep68: The Fiscal Stimulus and The Output Gap – A Messy Art Form

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PATTI BRENNAN: Hi, everybody, welcome to "The Patti Brennan Show." Whether you have $20 or $20 million, this show is for those of you who want to protect, grow, and use your assets to live your very best lives. Today, we're going to be talking about a really fun, entertaining concept. It's called the fiscal stimulus!

We're going to be talking about it with none other than the professor, Eric Fuhrman, Chief Planning Officer here at Key Financial. We're going to be doing something different this week. We're going to let all of you see how this sausage is actually made. Because we're talking about something like the fiscal stimulus, it's a messy art form, right?

We've prepared, and always prepare, lots of charts and graphs and things of that nature. When you're talking about something like this, sometimes it's just easier for you to look at the picture for you to be able to see what in the world we're talking about.

Welcome to the show, and Eric, most of all, welcome to the show for you as well.

ERIC FUHRMAN: Thanks so much, Patti. Great to be back as always. I love being in podcast studio with you talking about all these different concepts. I was thinking, we should come up with a name for you.

I've been given this term of "the professor" which is great. I've been called a lot of things in my life, that's a more flattering term. Maybe we should think about coming up with one for you.

PATTI: Patti: Good luck with that one. That's all I could say.

Eric: All I would say is we won't do it here because then you have to tune into next week's show to figure out what we're going to come up with.

Patti: There you go. That's a deal. That is a deal.

All right. We're talking about the fiscal stimulus and this art form. What we thought would be helpful is for us to attack these three ways.

Number one, we're going to go back in history and give you a historical perspective of what got us to where we are today. Then, we're going to be talking about this thing in terms of this output gap which is what theoretically the policymakers are targeting, and why deficit spending tends to work over time. At least we hope it does, right?

Then, we're going to be talking about where in the world do they come up with the number. $1.9 trillion. It's not $2 trillion, it's not $1 trillion. It's $1.9. Where in the world do they come up with that number? Eric, thank you so much. Welcome to the show.

Eric: Thank you, Patti.

Patti: Yes. First, let's go into that history lesson. We have been, as a nation, through a lot of different crises dating back to the early 1900s, but something has shifted. There's been a paradigm shift in terms of how our government leaders deal with crises.

Why don't you take us way, way back and bring us forward to help us understand why they're making some of the decisions they're making today?

Eric: Yeah, no problem at all. You can trace the origins of, and I love the way you phrased it, this paradigm shift in government policy to the Great Depression.

You have to understand how policy was conducted prior to the Great Depression, and in response to it, to understand where we are today. The response that occurred there still resides with us today, some, gosh, 90 years later.

I think you have to start with Herbert Hoover. His campaign slogan when he was elected was this idea of rugged individualism. As Americans, that message resonates with everybody, because we have always...It's part of our DNA to think that we are individuals, a belief in small government and not intrusive interference from a government body, and so forth.

He was elected on this campaign, but what happened is, the Great Depression, the stock market crash occurred about seven, eight months into his presidency. As the crisis worsened, his ardent embrace of this promise, a rugged individualism, was antithetical to the notion that any government stimulus would be used to solve the problem

The prevailing fiscal orthodoxy at that time was that the market was self correcting. That the government didn't entertain ideas of activist policies of interfering in economics because the market would solve everything, and this invisible hand would come through and everything would correct.

The government policy up to the Great Depression was all about balanced budgets. The idea was that, with a balanced budget, that would instill confidence among consumers and businesses and markets, and that encourages investment. Ultimately, it is investment that sustains but also provides the foundation for economic growth.

Again, that was the prevailing orthodoxy, but what happened is when the Great Depression occurred, Hoover was…Not that he didn't do anything. He instituted many policies and tried to work with businesses and so forth, but he was against the idea of providing direct aid to families.

His view, no government had ever done this before, and to provide direct aid was going to be ruinous to the morale and initiative of the country and edges closer to socialism.

He rejected growing calls for the government to intervene. Roundabout that time, the next election cycle, Franklin Roosevelt, his platform was based on the three Rs, providing relief, direct aid to families, recovery through government spending, and reform through the development of social safety nets, which we have today.

He won in a landslide over Hoover. Basically, he started unveiling these policies, which were completely different, as you said, a paradigm shift to what existed beforehand.

A lot of these policies were based on the teachings of John Maynard Keynes, who was a British economist during this period of time that advocated activist, what we call countercyclical government policies, where the government intervenes as a means to basically solve prolonged unemployment and so forth.

That's where all of this came about that still exists very much in today's fiscal policy.

Patti: I was fascinated during the break when we were talking about Roosevelt's propensity to issue executive orders. I was blown away by the number of executive orders that Roosevelt was doing on a year by year basis. Nothing close to what leaders do today. Want to give everybody a feel?

Eric: I thought this is so fascinating when we were doing the research and the preparation for this podcast. Because you watch the nightly news today, they make such a big deal about executive orders being issued by presidents because this is a way that they can enact policies without getting the approval of Congress.

Whether or not they're constitutional or not takes time to determine. If you look over, say, the recent three or four presidents that have been in office in our lifetime, 2 to 400 over their entire presidency, depending on whether they served two or three terms, is normal, so about 30 or so, 40 a year.

Roosevelt is the all time leader. He was elected to three terms in office. 3,712 executive orders, an average of a little bit more than over 300 per year.

Patti: Wow.

Eric: If you think today that they're abusing the executive powers, think about what they thought about Roosevelt in that day and age when he issued over 3,700 executive orders. Yeah, an interesting little tidbit that came out of the research.

Patti: The New Deal definitely went through the normal channels, right? It was Congress and the Senate all approved and said OK, we're going to do this thing.

Eric: Yep. This is where, again, they started providing direct aid to families. Social Security was part of this, 1935 or 1937, I think, is when that came about, the modern day Social Security system. It took a lot to get that, but there was significant economic improvement from 1933 through 1936.

He was elected again on a very strong recovery. He served three terms, which nobody can do nowadays.

The policies did work, and that gave them a lot of validity that this notion of deficit spending, the government doing the opposite of what individuals, you and I, households are doing, is a way to not eliminate the business cycle but reduce the amplitude of the business cycle.

Patti: Let's get into that a little bit. Let's go back and help everybody understand what that's all about. We've talked about this before. Your spending is my income. My spending is your income. That's the way a consumer based society works. When there's a crisis that occurs, what do we do? We all pull back.

We did this with COVID. Certainly, people stop spending money. Unfortunately, when we stop spending money, that means that somebody's not earning money. Unemployment, skyrockets, GDP plummets, and we languish. We run the risk of going into certainly a recession, but a severe recession and maybe in even a depression.

The goal here for government is to step in where the consumer stepped out. To your point, to reduce the amplitude and the severity of the economic outcome of the crisis and to smooth things over until the consumer can start feeling confident again. More secure jobs, jobs start to improve, people get employed again, and we go back to a growing economy.

That to me is the most important. Always remember that someone else's spending is your income. When that stops, something else has to happen. Otherwise, we could eventually get back into another depression. That's how that happened.

Eric: Income and aggregate falls when everybody pulls back. But what you're showing, and I think we'll probably put up a chart for our viewers, is this wonderful, very simple way to look at an economy, which is called the circular flow model. Where basically, firms and households just continue to spend in the cycle.

We spend to give money to businesses, businesses then spend through paying wages and buying goods and services, which then provides money back to households, and it just continues in this circular format.

Patti: It provides velocity as well, because, that business can use that income to help even more people as a result of our spending. I think that that's helped. A lot of economies are certainly recover in the more modern economy, in a more significant way.

OK, fine and dandy. $1.9 trillion, let's just put it in there. Where's the government going to get all this cash? I mean, we've talked about it before, Eric and let's face it. When Obama was president, he issued an $800 billion stimulus package and everyone was freaking out.

Eric: I remember. That number, at the time, it was so astounding. So astoundingly large to think about $700 billion or $800 billion. This is a magnitude of order above and beyond that, it's almost hard to wrap your mind around.

Patti: Over and above the $1.9 that we did last year, right? So where is the government getting this cash? Let's just go, professor, and give everybody a quick lesson in terms of this concept of printing money.

Eric: When the government needs to pay its bills, how does it do that? It can raise taxes, which would be a horrible idea.

Patti: By the way, paying its bills includes supporting families, etc. That's the government's bills.

Eric: Exactly.

Patti: Unemployment, insurance, things of that nature.

Eric: Exactly, right. So one way is they could raise taxes, but Hoover already proved in 1931, what did Hoover do in the face of the Great Depression? He wanted to balance the budget by increasing taxes and cutting spending, that only ended up worsening the crisis.

Today, when the government runs a deficit, what they do is they ask the Treasury Department to sell bonds to investors. Now, there's this idea that somehow the government just prints up the amount of money that they need. The United States doesn't work like that. That's not how it pays its bills.

If you look at, let's say, the Federal Reserve puts out what's called the Z.1 report, there are trillions, and trillions, and trillions of dollars in savings locked up in the financial system. These are bank deposits, money market funds investments, so when the government needs to pay their bills, what they do is they issue bonds to investors.

There's a wonderful intersection, because when there's a crisis, what do we just naturally want? What does our brain say?

Patti: The safest thing there is, which is treasury bonds. We want that safety and security that only a treasury bond can provide.

Eric: That's right. The US government is the sole issuer of the risk free asset in the entire world, which is US government treasury bonds. So what they do, they sell bonds. All that money that is locked, that savings that is locked in the financial system, the government sells bonds, they get the cash, and then what does the government do?

They spend it and that creates income. Income for households and businesses through aid and direct purchases, transfer payments, and so forth.

Patti: Yep. Again, just to nail this shot, the treasury bonds, OK, who owns the treasury bonds? When we talk about "they", always remember, we are they. We are a government of the people, by the people, for the people.

So when the government issues those bonds, and we buy them, whether it be outright or via a mutual fund, or a pension is...They tend to buy a lot of treasury bonds. We own the security. We own that. That's part of our net worth. I found it interesting, and we didn't talk about this, Eric. Larry Kudlow was on one of the channels a couple of weeks ago...

Eric: These guys don't show it now I hear.

Patti: I know.

Eric: They didn't take long, from on the government payroll, back to the private life on TV.

Patti: Absolutely. Good old advertising, works every time, right?

Eric: That's right. He set himself up nice.

Patti: Yeah, and you know what? He was talking about how wealthy our nation is. The household net worth alone is $122 trillion. That doesn't even include how wealthy our government is. Because our government again, our government is us because we are the nation of the people, by the people, for the people. So we own these assets also, but think about what the government owns.

They own all of those oil fields, real estate, tons, a lot of assets, is also part of our net worth. I've never seen anybody do a study and this is something that I'd love for us to do. How wealthy when you put the two of them together? I mean, I've heard that the oil fields alone are worth…Estimated to be $116 trillion alone.

Then you think about the real estate, you know guys, we own the White House. I think that's a pretty valuable piece of real estate. What do you think?

Eric: I don't know what it's worth, but who knows?

Patti: Yeah. So, OK, I get that. So they issue the treasury bonds, I buy a treasury, they have the cash, they spend it. So basically, the federal government is providing a bridge for our economy, to replace the spending that we're not doing temporarily. Again, just to get us through.

What is interesting to me is how they go about spending, how they choose to direct those funds, we'll get into that in a minute. Let's now talk about this thing called the output gap. All right? Why don't you define it and then I'll walk people through the potential versus the actual.

Eric: The output gap. Now, I don't know about you, but I had this weird…As we were going through this and developing ideas. We started looking into the output gap and this concept of multipliers and what they call marginal propensity to consume, which we're going to get into a minute.

I actually sat there and thought back to economics class, I'm like, "Oh, my gosh, I am actually going to use this, I can't believe it." Here it is, I thought I would never ever need this in my entire life and here we are, so there is a use it, believe it or not. Any people still in school listening, pay attention because you never know when you're going to need something from class.

Patti: You got it.

Eric: So the output gap is you define it. When policymakers are trying to determine if stimulus is needed, and how much, they have to determine what's called the output gap. The Congressional Budget Office or the CBO, they make calculations of what they call potential GDP.

This is a theoretical construct. It can't be observed in reality, but potential GDP is really an estimate of how much output can be produced sustainably without creating inflation.

If we employ all of the available people out there who could participate in the labor force, how productive they are, this is an idea of the maximum output that we can sustainably produce, and then there is what we're actually producing, and if we are below potential, you have an output gap. Pretty simple.

Patti: There's your gap. Basically, folks, when you think about the output gap and the potential, think about it like the safe speed limit. You've got the safe speed limit. If you go too far below it, then we've got a lot of idle workers, idle factories. We're not producing to the level that we probably can.

If we go too fast, then we're going much faster over the speed limit, and that could cause other problems. Think about it in terms of the safe speed limit, and, as Eric said, it's kind of…Well, these people are smart, but it can change quickly.

Eric: The important point here, which you and I see every day, which is when there's an output gap, there is a real human cost to that. That means people are unnecessarily unemployed or underemployed. There is a human toll that is taken when you have a negative output, that gap that has real consequences.

People let go from jobs and trying to figure out how to plan and what to do. We see the result of that when we go through these periods. It's very heartbreaking sometimes

Patti: It is heartbreaking. It is very real and very raw. It comes in the form of long lines, people going to food banks. Literally, people who used to work at the food bank are now in line, because they need the food themselves. These things have never happened to a lot of people before.

We'll put this in the show notes, and we'll put it on the video where you guys see the output gap, the graph that we've put together for you, you can understand very quickly why policymakers were as worried as they were and realized they needed to act really fast.

Again, it's a moving target. It's important to recognize that it is a moving target especially since the economy moves very quickly. You don't kind of know until after the fact even that a recession is occurring. Certainly, it's not declared over until months after a recession is officially over.

As we said, it is a messy art form. While it's effective over time, it's one that needs to be monitored. We have to be cognizant of the unintended consequences of some of the policies that are coming out.

Eric: Yes. What's so interesting, what you talk about, is this idea of a moving target because. The Congressional Budget Office uses very complicated statistical models run by PhDs, very smart people, but you're trying to forecast something in the future that is ultimately unknowable.

When you and I looked at the revisions of the output gap because the CBO will produce revisions as time passes. If you look at, say, last fall, if you think about where did the $1.9 trillion come from, keep in mind that they don't write a bill in a week. This is months in the making.

When the CBO came out in October, the output gap was huge for 2021 and beyond.

Patti: I will tell you, Eric, it was exactly $1.850 trillion over a two year period of time. That's what they were projecting. So, "Voila." Now I get it. $1.9. They're going to inject $1.9 to fix the $1.8 gap and here we are. Fast forward, what's the latest revision of the output?

Eric: Wait. Are you saying there's a problem?

Patti: No. No problem, whatsoever. All right, good.

Eric: That's what was so astounding. For us, because we operate in the financial markets, it was very encouraging news that the output gap had incredibly shrunk. It went from, what, for two years, from $1.8 trillion to $600 billion.

Patti: Right.

Eric: That's wonderful as an investor because that shows great signs of improvement.

Patti: I can't help but wonder if that has something to do with the $1.9 trillion that was passed last year because, as we all know, it takes a while for it to get into the system. It doesn't happen overnight. Here we are, February. The gap is much smaller, but what just got passed?

Eric: It's hard to even say, I'm sorry. $1.9 trillion with a "t" to solve a problem that has now become $600 billion.

Patti: Again, to Eric's point, it's not to take away from the people who are still struggling. There are people who are still struggling.

What was different with this particular package was that it seems to be aimed at the families who are still struggling. The people who remain unemployed, the families with young children. Some of these things are directly targeted to those people to give help right away.

Those people can't wait for three or six months for it to work its way into the system when they can get their new job and start working again and earning money and bringing food into the family. They need money now.

When we talk about this, we talk about it within that framework and understanding that this is really important. This is what our government is for. I will tell you that I'm happy that it got passed. Yet, at the same point, we have to be aware of what could happen on the other side.

Eric: What's interesting is now we might venture a little bit more into the theoretical angle of stimulus, but it's this idea of multipliers. It is not to say necessarily that 1.9 trillion is more than you need.

It could be exactly right. It might actually be not enough. It depends on this Keynesian concept that was espoused back in the 1930s of marginal propensity to consume. If the government spends one dollar of stimulus, that's great. You and I as individuals, we have choices. We might spend it, but we could also save it. We might use it to pay down debts.

When policymakers put these together, they are dependent or hopeful that the money will be spent. Because if you save or invest, that money is not creating income for somebody else in this circular flow between households and businesses.

It's this marginal propensity. What is the multiple? If I spend a dollar, how much of that actually gets spent? Sometimes it's more than a dollar, sometimes it's less. It depends on who you give it to.

Patti: Eric, I want to frame something because I never want to assume that our listeners know this stuff. When we invest, let's take that concept of investing, investing into the stock market. Let's say that you're buying Amazon stock. You all need to know that that's not helping Amazon. Amazon is not getting that growth.

There is an indirect benefit that Amazon might get, but they don't get that money. It's not like if their stock doubles in price that they're given that money so that they can hire more people. Again, to Eric's point, we either spend the money, save and invest it, or we pay down debts.

You can begin to understand why policymakers may target particular families, people who really, A, need it, lower income people, people who may be out of work, and, B, the people who are more likely to spend it because that's what's going to improve the economy.

Saving, investing, and paying down debt doesn't do anything for the economy. That's what a policymaker needs to focus on.

The idea of the multiplier, to me, brings it all home in a way that OK, now I get it. It doesn't necessarily mean that all this money sloshing around is going to lead to ridiculous amounts of inflation because, to be honest with you, not everybody's going to spend it.

For every dollar, depending on where it's targeted, you might get a multiplier of 0.6, for example, or 0.4. It has less of an impact. It still has an impact but not quite as much as you might think.

Eric: Absolutely right. The question is you want to direct the spending policies to people that have a high likelihood of spending it. That would be, for example, increasing unemployment benefits.

Even with these direct stimulus checks, they are putting an income limitation on it. It's not going to people at the higher levels of the income scale who are probably more apt to save it.

If you take the current package that's been out there, it's 1.9 trillion. When you break it apart, something like roughly 50 percent of it goes to direct aid and Supplemental Nutrition Assistance. Another 40 percent, I believe, goes to states.

Those are things that are likely to have high multipliers because people in need or state governments don't have an incentive to save, so they're likely to spend the money. There's likely to be a high return on those dollars that are flowing into those different entities.

There is a intelligent design behind it. The question, because things have improved so much, would be is it enough, or isn't it enough? Consensus views on that, they're...

Patti: All over the map.

Eric: Yeah. I should say professional forecasters are all over the map on that.

Patti: Let's keep it real. What are the risks? What are the risks of an undershoot? What are the risks of an overshoot? I think about what they did during the financial crisis.

We've talked about this before. Every time we have one of these things, our leaders learn. What they learned from the 2008 crisis is that the stimulus was good, but it took too long for it to be effective. The economic recovery was quite lethargic.

Unemployment, we didn't get to follow employment for many, many years. The economy never really got up to that juicy three percent average GDP that is the target.

The one thing that they're trying to avoid is having that story repeat itself, so they're flushing the economy with trillions of dollars. What's the risk of an overshoot? How are we going to know it? If it does happen, Eric, what in the world are going to do?

Eric: I don't know if we can bring up that slide of the output gap here for this. You make a great point, which is they had massive stimulus, but look how long it took. It took almost 10 years from the financial crisis until we finally got back to potential. It took that long that we were underperforming.

The lesson, as you correctly point out, is that policymakers would much rather favor an overshoot and to try and flood as much into the system as quickly so that the recovery is much faster. We don't have this very long, drawn out period.

You're right. If they overshoot, and they overshoot dramatically, what's the outcome? Most people would worry about inflation. That would be the big outcome.

It seems like the Federal Reserve is communicated. They are more than willing to allow inflation to be above target for some period of time. They've got new guidance on that. They seem confident that they have the tools to rein an inflation if it becomes a problem.

Patti: The new target, for those of us who have been around for a little while, is above two percent. I will tell you that when I first started over 30 years ago, the thought of a two percent inflation rate was like Nirvana.

It was riding at six percent, seven percent. Our mortgages were much higher, etc. That's a very low inflation rate. That's what our leadership has determined that is very sustainable. Let's pull this together. By the way, we can talk about the Federal Reserve and all the tools they have to dampen the inflation.

Eric: I might refer our listeners back to the wonderful podcast we did last year, part one and two on the national debt. There's a lot of parallels between this and that.

Patti: You know what we should do also? I'm going to do this. I'm going to commit to this. Let's take our papers, the work that we did to prepare for those podcasts because we weren't filming at that time.

We're going to put those on the website. There, you're going to see how the story unfolded, all of the graphs and charts, and the things that we did, and the research that we did over the summer.

I will try you, I was taking a course from Professor Fuhrman. I might have thrown in a point or two. It was interesting stuff to the extent that you want to understand this. At the end of the day, we just want to share the information in a way that, hopefully, you can understand it and give you confidence that while it is messy, they're figuring things out.

Number one, we have the benefit of a rich history. Boy, do we ever. We've been through a lot on this nation. Little by little, slowly but surely, we seem to be getting out of these crises. It's not that we don't have them. It's just that we know what to do when it happens.

We learned how deficit spending is used, and how it's used, and why it's used to bridge the gap so that the depth of the crisis isn't nearly as deep as it would be normally.

Last but not least, we learned about the output gap and where our leaders come up with this magic number of $1.9 trillion, and how they think about who's going to receive that, and how that's going to come into the economy.

Eric: Maybe a good way to bring it to closure that you and I were talking about is that now, we're starting to see economic estimates of what the growth forecasts is going to look like, not only for this year but next year. It's eye popping in terms of numbers. This fiscal stimulus has a lot to do with that when we think about our near term outlook over the next one to three years.

Patti: We talked before about Ben Bernanke's 60 minutes broadcast. At that point, he talked about the fact that he was beginning to see green shoots coming out of the ground. Let me tell you something. This is bamboo. This is growing like crazy. Estimates are close to six percent GDP for this year alone.

It actually trends down. It'll be very interesting. I know we're nerding out on you, by the way. I apologize for that. It's comforting. I like to read and understand this because it makes me feel more confident in our leadership. We're going to figure it out. That's the way these things tend to work.

Eric: Nerding out is OK. My favorite times at Key Financial is when you nerd out.

Patti: Totally. Eric, one thing that we have to remember also is that we're all doing this. They're all doing this. We're having all this stimulus in the midst of something that never happened before. That is six foot social distancing. We're not able to go out there and spend the money that we normally would. What does that look like?

Eric: There is a well established history where academics can go back and figure out how effective stimulus was after the fact. You never had to it when social distancing was there.

Part of me thinks that, yes, the package seems larger than the problem, but you've never had an issue with social distancing. How effective can it be in an environment like we've never ever seen before? We'll learn a lot. I know that much.

Patti: Hey guys, I'm still Latina. There is no alternative. People are saving it and investing it. That has something to do with why the market has been going up as well. Not everything. There are real, fundamental reasons, but there's no other alternative.

Anyway, fun as always, Professor. Thank you so much for all the research and the back and forth you and I did over the weekend. I appreciate that, and I appreciate you.

These podcasts don't happen unless you are tuning in, and you are listening. We are hearing so much from you. I'm so grateful that you make us feel as if this is worthwhile, that it's making a difference in your lives. Honestly, that's what it's all about.

I'm Patti Brennan, Key Financial. Eric Fuhrman. Thank you, Professor. I hope...Go ahead.

Eric: Highlight of my day.

Patti: Highlight of your day. Now we going to get back to work. I hope you all have a terrific day. Take care now. Bye Bye.