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Time to Develop a Fiscal Recovery Plan
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Over eighteen months into the recession, the economy still faces a number of challenges: the banking sector has not yet recovered; the consumer de-leveraging process has only just begun; housing prices are continuing to fall; and unemployment (a lagging indicator) has risen in recent months and will likely continue to do so. Given the need for stimulative government spending, it would be premature to begin reducing our budget deficits and enormous federal debt as the economy struggles to find its footing; in fact, some are making the argument that a third round of stimulus may be needed.

That said, the massive borrowing we are undertaking – both to finance current stimulus spending and large underlying deficits – also threatens the country's economic well being. Projections from the Congressional Budget Office (CBO) show that debt held by the public will surge from 41 percent of GDP last year to 60 percent by the end of this fiscal year and hit a record high 128 percent by 2050.

The challenge is how to best meet the seemingly contradictory goals of providing the economy with sufficient stimulus, yet doing so in a fiscally responsible manner. ***The answer is to continue with stimulus policies as necessary, but, in order to regain the country's fiscal credibility, to promptly develop and announce a plan to reduce the deficit and close the long-term fiscal gap. This plan would be implemented as soon as the economy is strong enough to absorb it.***

While it would be premature to withdraw needed economic stimulus by reducing current budget deficits, there are signs that failing to take action to address our mounting public debt could also jeopardize the recovery. As the economy showed early signs of improvement in the spring, "bond vigilantes" immediately demanded higher interest rates on U.S. debt instruments because they perceived a shift in risks related to higher inflation or default from an unsustainable U.S. debt outlook. Our major foreign creditors, including China, Russia, Brazil, and South Korea, have publicly cautioned the U.S. about the huge debt build-up – an early sign that we may not be able to continue borrowing cheaply from them in the future.

Higher interest rates – a likely outcome of ongoing large borrowing needs – threaten both to choke off recovery and to add to federal interest costs. According to CBO, if interest rates are higher than it had projected for the next ten years, future deficits will be considerably larger because of increased debt service. In one of its plausible scenarios, an increase in interest rates along the lines expected by the top ten forecasts in the benchmark Blue Chip Consensus would add $1.2 trillion to the already high cumulative budget deficits projected by CBO over the next decade.

It is critical that the U.S. government has fiscal credibility during times of economic and financial crisis, in order to give it more fiscal room to maneuver by keeping down borrowing costs and maintaining the confidence of creditors and taxpayers.

In order to regain its fiscal credibility credentials, the government must develop a plan to return the budget to a sustainable path now, rather than wait to be forced into action through a fiscal crisis. Such a crisis could take a number of forms, such as a sharp run-up in interest rates as investors demand compensation for their fears of hyperinflation or default; or a rapid fall in the dollar as creditors seek less risky investments elsewhere. A crisis could also be more gradual: as the economy heads toward full employment, interest rates will head up, choking off productive investment and ultimately lowering our standard of living.

Experience in many foreign countries, including those in the EU that adopted the euro, suggest that advance announcements of what economists call a "medium term fiscal consolidation plan" can help avert these types of crises by having a positive impact on expectations related to challenging debt problems. This, in turn, would translate into a stronger financial position for the U.S. and savings for the taxpayer.

Once an economic recovery is on solid footing, the fiscal recovery plan should be implemented gradually. Any such plan would likely include changes to the largest entitlement programs, other areas of government spending, and the revenue side of the budget. It will not only serve to reassure markets and strengthen an economic recovery, but it will also offer the public a realistic understanding of what will be necessary to fix the disastrous budget situation we now face.

The best roadmap to recovery includes continuing with stimulus policies as necessary, but also sending clear signals that the U.S. will reduce the deficit, lower its debt, and close the long-term fiscal gap once the economy is strong enough. American fiscal credibility will be strengthened if a long-term deficit reduction plan is publicly presented along with short-term stimulus.