

Comment on “The Budget Crisis: Is It All Deja Vu?” by Barry Bosworth

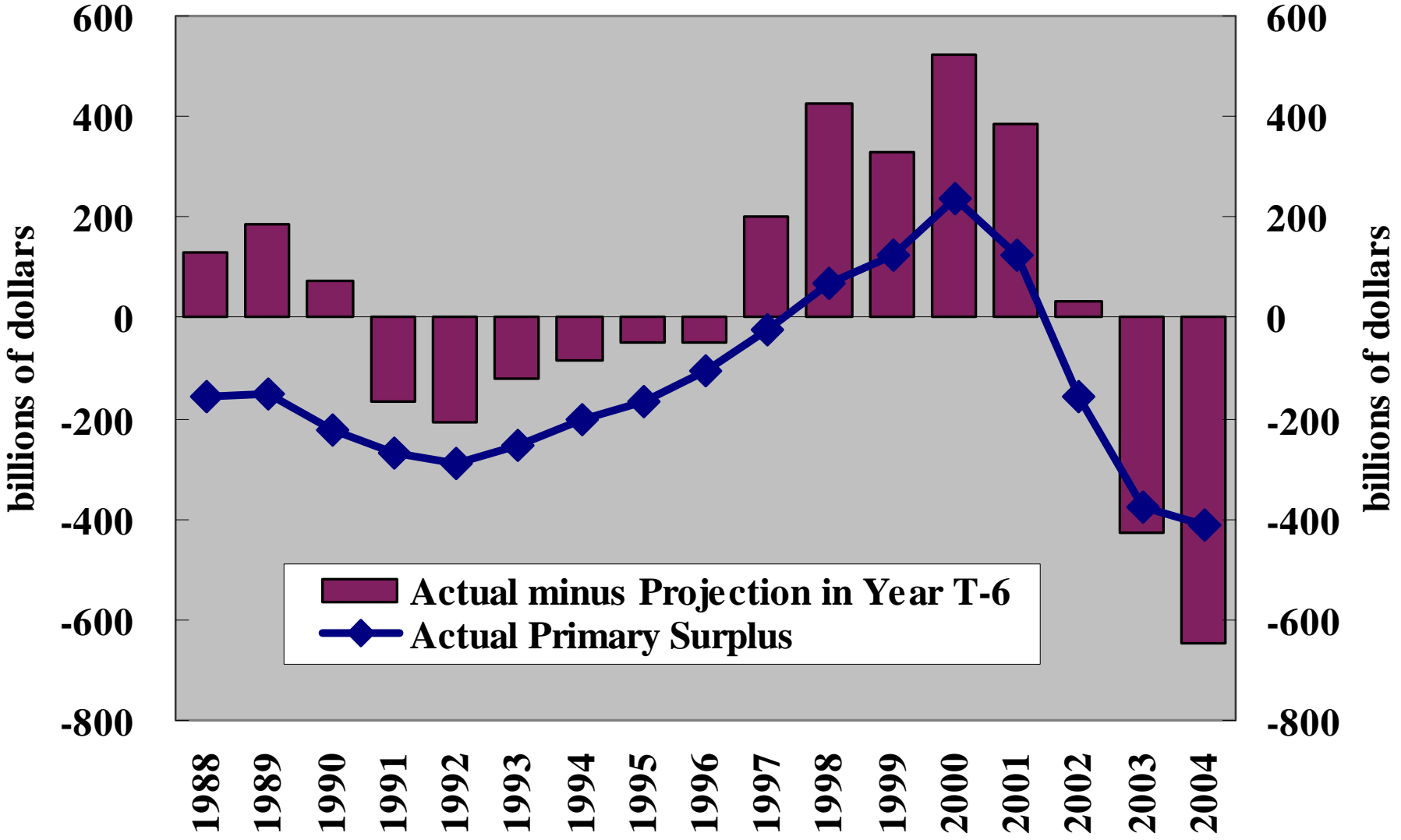


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My questions/comments

1. Are we intelligent enough to make a reliable prediction about the budget surplus/deficit?
2. Is there any new role of fiscal policy in a very low inflation environment (or, in a liquidity trap) ?
 - “The use of fiscal policy for stabilization purposes fell into some disfavor among economic policy makers during the 1980s and 1990s, primarily as a reflection of a belief that monetary policy would be more effective and timely. **However, there has been some resurgence of interest more recently as concerns emerged about the efficacy of monetary policy when interest rates approached a zero limit.**” (footnote 14, page 9 of the paper)

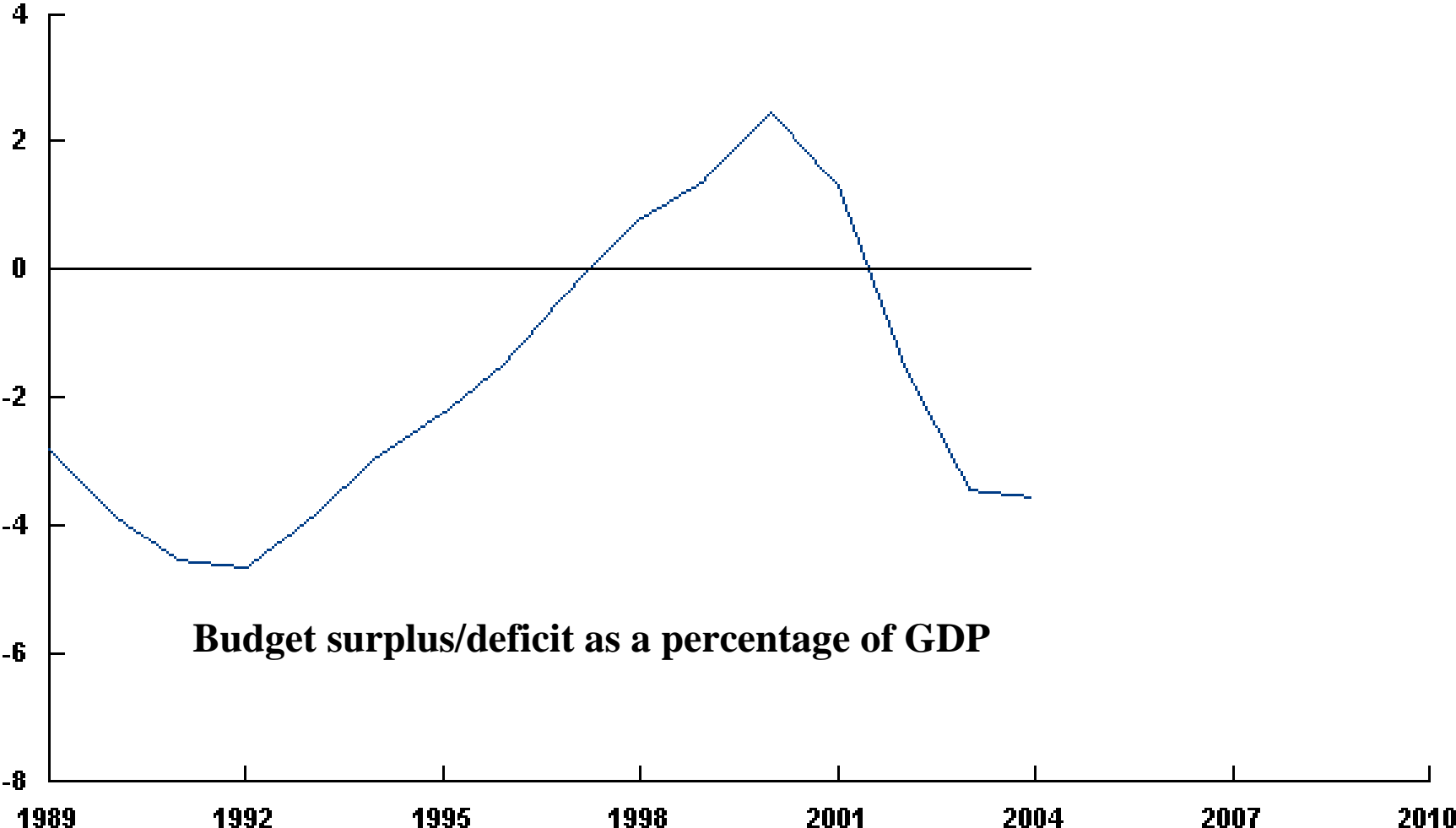
Were prediction errors random?



Revisions in Fiscal Balance Projections

	US: Projected by CBO			
Projection year	02	03	04	05
1997	-189	-202	-219	75
1998	70	54	71	256
1999	209	210	233	376
2000	208	227	246	433
2001	313	359	397	103
2002	-20	-15	54	-73
2003		-199	-145	-362
2004			-477	-368

Can we make an accurate prediction?



Budget surplus/deficit as a percentage of GDP

Source: CBO, "The uncertainty of budget projections: a discussion of data and methods," February 2005. ⁵

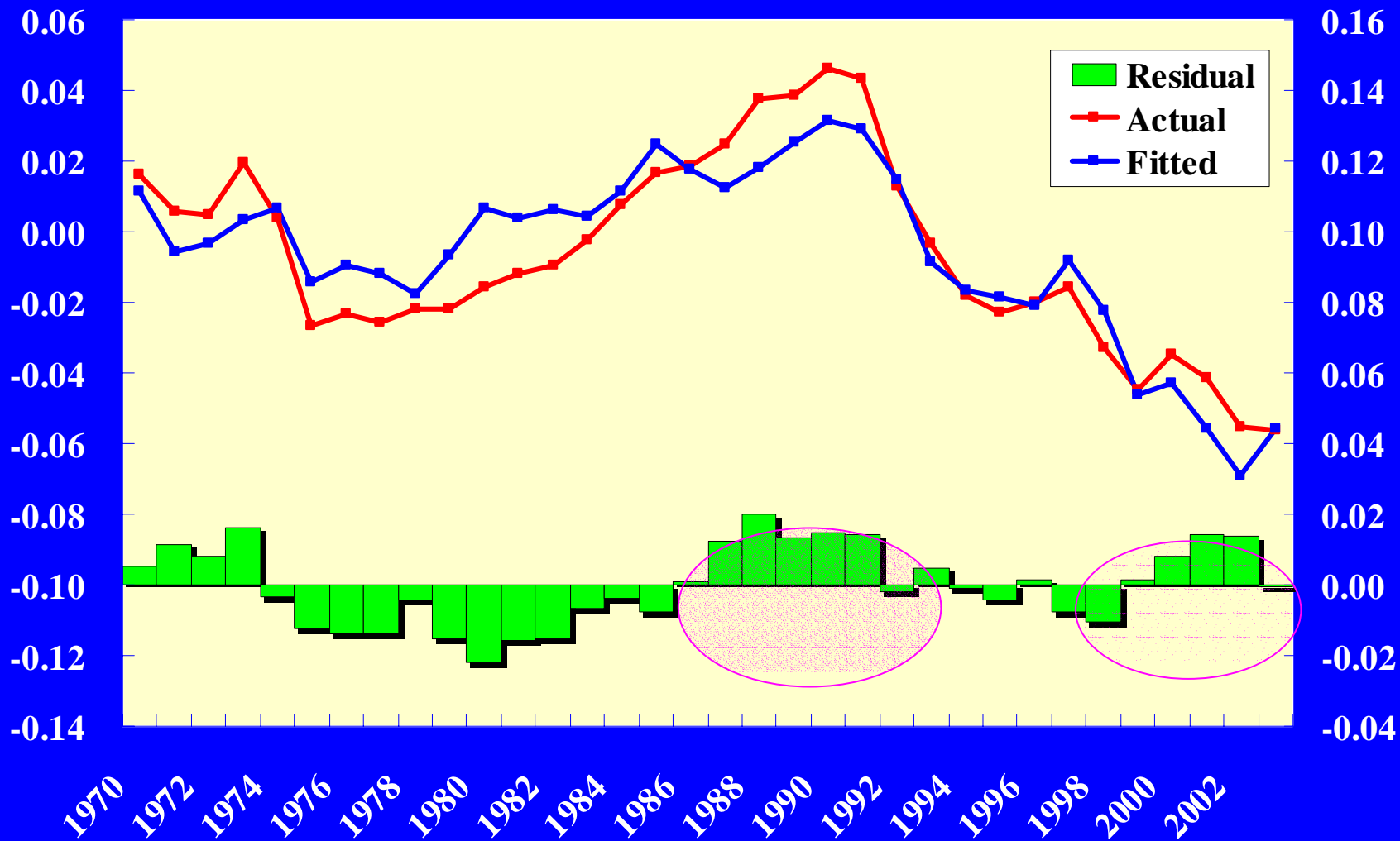
Comment #2: A new role of fiscal policy?

1. **Natural rate of interest falls below zero**
 - (Wicksellian) natural rate of interest is defined as what the equilibrium real rate of return would be if prices were perfectly flexible
2. **But the central bank cannot lower nominal interest rate below zero**
3. **Real interest rate (nominal minus expected inflation) is higher than the natural rate counterpart.**
4. **Monetary policy seems to be ineffective. Need some help from fiscal policy?**
5. **No consensus on this issue, but some argue that the government should become a Non-Ricardian (e.g. Benhabib et al. (2002)).**

The lack of fiscal discipline (Non-Ricardian) => The transversality condition is not satisfied without a positive inflation => Successful escape from the liquidity trap

However, the Japanese government has been sticking to fiscal discipline (Posen and Kuttner (2001), Iwamura, Kudo, and Watanabe (2005)), so we don't know what would happen if the government deviates from the Ricardian fiscal policy.

Estimated Ricardian Fiscal Policy Rule



Source: M. Iwamura, T. Kudo, and T. Watanabe, "Monetary and fiscal policy in a liquidity trap: The Japanese experience in 1999-2004," NBER WP 11151, February 2005