

## **Appropriate Roles of Monetary and Fiscal Policies**

Mickey D. Levy  
Bank of America

Shadow Open Market Committee  
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The financial crisis and recession are over. Global economies are rebounding at a healthy albeit uneven pace. The US is recovering slowly. Inflation is low in the US and Europe, and the probability of deflation is low, while Japan continues to struggle with mild but persistent deflation. Inflation pressures are mounting in fast-growing emerging nations.

Global macroeconomic policies vary widely. Most notably, US monetary and fiscal policies maintain a short-run focus, driven primarily by high unemployment, and seemingly brace for the worst possible conditions, while Europe has moved decidedly toward fiscal austerity and the European Central Bank has discussed its exit policy. China, India, Brazil and other emerging nations' central banks have begun to hike rates. Japanese monetary and fiscal policies remain in a muddle-through mode, and Japan has intervened in an attempt to prevent further yen appreciation.

Both US monetary and fiscal policies have deviated significantly from their long-run sustainable trends and objectives. With the economy growing slowly and unemployment high, macroeconomic policymakers debate whether they should pursue further stimulus, and when policy should be put back on track toward long-run sustainability.

US fiscal policy is in complete disarray. The fiscal stimulus failed to stimulate the economy or create many jobs. Government debt is surging, with unknown costs, and the uncertainty about tax and spending policies is undermining credibility and private sector confidence. US fiscal policy requires change—the kind of change that is already taking place globally—and it desperately needs a roadmap toward long-run fiscal responsibility. The thrust of US fiscal policy must be shifted away from short-term, temporary programs, and deficit spending targets must be established that require legislated reductions in future deficit spending and entitlements reform that will be implemented over a reasonable period of time.

The monetary policy debate about more quantitative easing brings up a host of issues regarding the efficacy of monetary policy, and whether current slow growth stems from insufficient demand that potentially can be remedied by monetary stimulus, or from structural problems related to necessary elongated adjustments to household balance sheets and distressed housing sector and mortgage market, that are likely to be resistant to more monetary stimulus. With the financial system already awash in liquidity, and the economy and job creation constrained by a host of nonmonetary policy factors, more quantitative easing at this point is a low-benefit policy course with potentially high long-run costs, and should be avoided. Instead, addressing barriers to growth directly through nonmonetary means (i.e., dealing with the millions of distressed homeowners facing foreclosure) would be a surer route to healthy expansion than excessive reliance on monetary stimulus.

### **The environment for US macroeconomic policy**

Output and job losses during the 2008-2009 recession were significantly larger than prior recessions, and although the US economy continues to recover, with real GDP and final sales growing at a pace similar to the recoveries from the 1990-1991 and 2001 recessions, the lack of job creation and persistently high unemployment is striking. Through 2010Q3, while real GDP has rebounded an estimated 3.5 percent from its recession low to within one percent of its prior expansion peak level,

nonfarm employment is 130.3 million, or more than 5.5 percent below its prior peak, and the average duration of unemployment has surged.

All policymakers want healthier economic performance—stronger growth and lower unemployment. The critical issue is the proper roles of monetary and fiscal policies in achieving those desired outcomes.

As policymakers consider their next course of action, they face critical issues: What explains the weak response of domestic demand to the unprecedented monetary and fiscal stimulus? Does the soft growth in consumer spending and sustained weakness in the housing sector stem from insufficient demand or from structural constraints imposed by adjustments to high household indebtedness and the huge number of distressed homeowners, many of whom likely face foreclosure? Are the financial intermediation channels impaired in ways that would inhibit the intended impacts of more monetary stimulus and require nonmonetary policy remedies? Besides weak domestic demand, are additional factors inhibiting job creation? *More-of-the-same macroeconomic stimulus that does not address these issues is unlikely to achieve its desired outcome.*

Consumer spending and housing have been weak and unresponsive to macroeconomic stimulus, in sharp contrast to their leading roles in typical economic recoveries. The moderate pace of consumer spending reflects increased household saving and debt reduction, necessary and desirable trends that are likely to continue.

The vast majority of the run up in private sector debt prior to the financial crisis involved a dramatic increase in consumer debt, primarily mortgages and home equity loans. International experiences suggest that following unsustainable increases in private sector debt and financial crises, the deleveraging and adjustment processes take many years, typically involving below trend GDP growth and above-trend unemployment.

The rate of personal saving has increased from a low of 1.2 percent in 2005 to almost 6 percent, while real consumption has grown an anemic 1.5 to 2 percent annualized. Household indebtedness has begun to decline as a consequence of debt repayment, tighter bank mortgage and consumer credit standards and write-offs. Banks and finance companies report declining loan delinquencies and losses on consumer credit. Lower interest rates have trimmed household debt service, which has receded from almost 14 percent of disposable income to 12 percent most recently. The level of household debt remains too high relative to disposable income and wealth and needs to come down further; thus, weak consumer spending and a higher saving rate is likely to persist and limit the response to further monetary stimulus.

The housing sector needs more time to adjust, and there are major obstacles to clearing out the excess supply: the rate of homeownership remains too high and millions of distressed homeowners face foreclosure and have upside-down mortgages, which will add to the excess inventory of unsold existing homes; government policies have failed to reduce the backlog of foreclosures and are presently imposing regulations that delay foreclosures; and these factors contribute to uncertainty about future home prices and prevent market-clearing price adjustments.

Amid these adjustments to demand, businesses have become very risk averse. Following dramatic cutbacks during the recession and financial crisis, businesses remain very uncertain about future product demand and have been hesitant to build inventories, hire or expand capacity. While their primary concern inhibiting job creation is weak product demand, many businesses also cite uncertainty related to future taxes, health care costs and regulatory burdens.

Construction employment has fallen over 2.1 million since the housing peak, accentuated by declines in business investment in structures and state and local government infrastructure spending. These job losses have been a major contributor to higher overall unemployment. Further monetary stimulus cannot lift these sectors.

Much attention has focused on bank lending as a constraint on business expansion. Empirical research suggests that weak bank lending is primarily a function of weak product demand. Tight credit standards may constrain credit supply in select sectors (real estate, and according to NFIB surveys, some small businesses). Unclogging constraints on credit must be resolved through administrative means, not monetary stimulus. Moreover, bank commercial and industrial loans are a lagging indicator and always follow a cyclical acceleration in aggregate demand.

Rebounds in exports and business investment in equipment and software have added significantly to GDP and are expected to remain strong. Exports benefit from the global economic rebound and the large productivity gains of US businesses that have reduced unit labor costs relative to overseas competitors. Businesses continue to invest in productivity-enhancing equipment and software, and their investment spending is stimulated by strong corporate profits and internal cash flows. Despite the rebound, business spending on equipment and software remains well-below its prior expansion peak.

**Necessary adjustments to reduce imbalances.** International experience suggests that adjustments following large private sector debt surges and financial crises are long and difficult. Many US policymakers find the required adjustments—higher US saving, lower consumption (spending on goods and services as well as housing), and stronger exports—politically unacceptable. Faced with the political costs of high unemployment and at a loss regarding what to do with millions of distressed homeowners, policymakers want quick fixes and tend to underweight the long-run costs of these quick remedies.

### **Monetary policy: beware of limitations**

The Fed's policy responses to the financial crisis—providing liquidity through alternative facilities, injecting capital into a fragile financial system, lowering interest rates and quantitative easing and helping to restore credibility of leading financial institutions through stress tests—helped to end the crisis and recession and stimulate the economy.

The Fed has signaled that it is leaning toward more quantitative easing. Noteworthy, its rationale for more QE has changed. Until recently, the Fed argued correctly that QE would be an appropriate monetary policy response to combat deflation or expectations of deflation. Fed Chair Bernanke and other Fed members have said that this would best be accomplished by tying QE to an inflation target. The present situation is different. Although inflation is below the Fed's desired 1.5%-2% implicit target, the probability of outright deflation is low, and Fed Chairman Bernanke notes that expectations are well-anchored to low inflation. Aggregate demand is sufficient relative to productive capacity (with nominal GDP growth comfortably above estimates of potential), and displays no signs of declining. Downward pressures on prices are selective and not general across a wide array of goods and services. The weaker US dollar is pushing up import prices.

The current Fed rationale for more QE is that while the probability of deflation is low, the slow rate of economic growth is insufficient to bring down the unemployment rate. Unfortunately, more quantitative easing would not materially stimulate economic growth or job creation.

Standard macroeconomic models used to estimate the economic impacts of more monetary stimulus, including those augmented by more sophisticated credit channels, provide overly optimistic assessments because they do not capture the structural characteristics that constrain consumption and housing, the nonmonetary factors clogging up the financial intermediation process (in addition to bottlenecks in the mortgage markets, banks, facing squeezed margins due to the zero bound on nominal rates and the new financial reform legislation, will pass on costs to borrowers) or sources of business risk aversion. The response of consumption in response to more QE and presumed lower bond yields will be low.

Mortgage interest rates are already very low and financial markets flush with liquidity, as the Fed maintains roughly \$1 trillion of excess reserves in the banking system. More QE would reduce mortgage rates, but the impact may be muted by higher costs of governance and compliance resulting from financial reform. Until the millions of pending foreclosures are processed and the housing market is 'unclogged', with home prices able to reach market-clearing levels, more monetary stimulus will have a muted impact. Presently, government administrative procedures are delaying the adjustments that ultimately will be required. Standard macromodels do not reflect these constraints.

Inherent in these arguments is the need to weigh the limited benefits of more QE against uncertain but potentially significant costs. Although inflation is not a near-term concern, the inability of more QE to overcome current obstacles to stronger growth would damage the Fed's credibility, further impinge on its independence and open the Fed to public pressure to provide QE at any time in the future when economic growth is soft and unemployment high. A bias toward further monetary stimulus and a trend toward providing liquidity as a substitute for direct but politically less appealing mechanisms for improving the economy is a poor precedent for monetary policy management, with potentially costly impacts on US economic performance.

### **Fiscal policy: a roadmap toward fiscal responsibility**

US government finances require immediate corrective action, on several fronts. Amid this low-growth economic recovery, quick implementation of massive fiscal austerity, especially in the form of new large tax increases, would be unwise. But important steps can and should be taken. US fiscal policymakers must learn from the positive shifts toward fiscal responsibility in other nations that face similar fiscal problems.

The crisis in government finances has many dimensions. First, government budgets and fiscal policy remain opaque, in sharp contrast to the heightened transparency in monetary policy. This critique applies to the Federal Government's unified budget, from which key programs are purposely excluded, as well as the massive and mounting unfunded liabilities looming over Federal and State and Local government budgets that do not appear on their cash flow budgets. This lack of transparency contributes to public confusion, creates an incomplete and distorted basis for fiscal policy decisions and increases the probability of undesired surprises. Second, the failures of the 2009 fiscal stimulus to stimulate economic growth and create jobs, and widespread concerns about the efficacy of other government fiscal and social policies (the various programs to help distressed homeowners, the health care legislation, etc.), have undercut the government's credibility and are restraining economic performance. Third, unlike prior episodes of large deficits, the budget imbalances are so large that they cannot be reduced sufficiently through healthy economic growth, and there are no guidelines or rules to lead policymakers to make the necessary spending and tax policy reforms.

**The need for transparency.** Immediately, governments at all levels should move toward complete transparency. The Federal unified cash flow budget must be comprehensive and include the outlays and

receipts of all government programs. For starters, it should include the full finances of Fannie Mae and Freddie Mac, similar to their budget treatment by the Congressional Budget Office. In addition to its unified budget, the Federal government should develop and make available to the public an “accrual budget” that provides projections of unfunded liabilities (including Social Security and Medicare) and the assumptions and rationale underlying those estimates. Similarly, State and Local governments should be required to develop and publish accrual budgets that reflect their unfunded liabilities stemming from public pensions and health care programs, and the assumptions underlying those projections, including assumptions and rationale on expected rates of return on pension assets.

Elected officials need to understand these budgets (and what goes into them) and so does the public; transparency would significantly enhance fiscal policymaking. US fiscal policymakers must learn from the successful examples set by other nations: the heightened transparency in government finances in the European Union and in many nations has improved public understanding and enhanced fiscal policy. There is more consistency of budget practices and measures, which facilitates debate and agreement on guidelines, required changes and a roadmap for achieving fiscal guidelines.

**Shifting from short-run fiscal stimulus.** The fiscal stimulus package has had little impact on economic growth or jobs not because of its size (\$800 billion); rather, its effectiveness was undercut by poor design, including many costly provisions that either changed the timing of spending and resulted in unintended side effects (the “cash-for-clunkers” program, for example), were temporary and costly attempts to boost consumption that instead were saved (one-time \$250 cash distributions to senior citizens) or were grants to states that had “multipliers” close to nil and were used to close state budget gaps and in effect avoid or delay necessary pro-growth reforms.

Far too little of the package was allocated to infrastructure spending and investment, and even those funds were disbursed by state and local governments to pet projects (including “shovel ready” projects) that largely involved misallocation of resources. I quipped at the time of enactment that the US should have adopted China’s fiscal stimulus program—it was skewed heavily toward investment and infrastructure projects truly designed to expand productive capacity—while China should have adopted the US’s package—which was aimed largely at income support and boosting current consumer spending.

The US economy has little to show for the highly advertised stimulus package except for higher government debt and the loss of government credibility. This has undermined confidence and contributed to risk-averse behavior in the private sector. That credibility can only be won back with sound policies.

To mitigate the financial burdens of unemployment, maintaining extended unemployment compensation is appropriate. Further efforts to boost the economy and jobs through short-term, temporary stimulus policies should be curtailed. They should be replaced with investment spending geared toward increasing productive capacity and encouraging innovation, and incentive-based programs that encourage permanent job creation. Temporary stimulus programs that are destined to fail precisely because they are temporary must be avoided.

The sustained wide gap between business production and employment suggests that there are factors beyond product demand that are inhibiting job creation. An effort must be made to address these factors, including identifying and addressing burdensome regulations and unnecessary costs, and reducing uncertainties that are deterring businesses from hiring and expanding. These steps will require

creative and cooperative efforts by the government well beyond standard macroeconomic stimulus remedies.

**Addressing the long-run budget imbalance.** Two points are obvious. First, as has been well known for decades, closing the long-run budget imbalance ultimately requires reforming the benefit structures of entitlement programs and reducing their long-run liabilities. The recent health care legislation will only make that long-run task more difficult. As the bulk of baby-boomers approach retirement, waiting only drives up unfunded liabilities and makes the task more difficult. All other federal government programs—including defense—are too small to make a difference to the long-run budget imbalance. Second, achieving fiscal responsibility ultimately will involve a compromise between spending cuts and tax increases. The budget imbalance is so large that relying too heavily on tax hikes would materially damage the economy and impede or reverse progress toward improving government finances. So policymakers must avoid taxes that harm future growth and productive capacity.

Timing the appropriate steps toward long-run fiscal responsibility is tricky. A massive shift toward fiscal austerity, particularly through tax hikes, would harm the economy; on the other hand, the current disarray in fiscal policy adds uncertainty and damages current economic performance while long-run budget prospects continue to worsen. It is critically important to remember that not all deficit reduction is equivalent; spending cuts and tax increases have different economic impacts, depending on how they allocate national resources and influence economic decisions.

A consistent research finding is that tax increases have a decidedly greater negative economic impact than spending reductions, in both the short and longer run. Reducing future government spending programs is likely to actually boost potential growth, whereas tax hikes tend to reduce potential. This finding is consistent with the positive response to Europe's recent austerity measures: cuts in deficit spending have not materially harmed economic performance and have improved public confidence. This contrasts with many previous IMF attempts to stabilize economies that failed because they relied heavily on tax increases.

The overriding point is that establishing longer-run budget guidelines, with an emphasis on controlling outlays and a reasonable timetable for implementing fiscal austerity, would impose discipline, force political compromise, and help to rebuild credibility without unduly harming near-term economic performance.

A number of nations have imposed fiscal rules that have worked to bring order to budget policy. Many nations have legislated caps on deficits, spending and government debt limits, and established independent fiscal agencies to monitor progress. The most successful measures have been numeric rules based on comprehensive budgets that are transparent and easy to monitor, impose sanctions for violations and provide some flexibility for recessions and other select special circumstances. Stand-alone debt ceilings don't work well, as the increases in debt are a lagged consequence of the government outlays and taxes. The US experience with its debt ceiling—and the political grand-standing when it is increased—illustrates the shortcomings of debt ceilings as a vehicle for achieving fiscal order.

Expenditure rules, which have been used in several South American nations, select European nations (including Sweden and Finland) and Canada, have proved effective. Deficit targets also have become more prevalent, and have proved successful. The European Union's Stability and Growth Pact of 2002 (and its predecessor, the Maastricht Treaty of 1992) has imposed a discipline on the government finances of its member nations, and despite violations, it has deterred higher deficit spending. The legislated deficit reduction guidelines enacted in response to the European financial crisis in 2010 have

imposed aggressive fiscal austerity in select EU nations. Deficit spending has been reduced, economic performance has not suffered and public confidence has been boosted. Political commitment to rules/guidelines is critical to success.

The US would benefit from a flexible fiscal rule—one that imposes discipline and a roadmap for fiscal responsibility. Presently, a Gramm-Rudman “pay-go” rule would be insufficient to bring fiscal order in light of the magnitude of the long-run budget gap. Moreover, although Gramm-Rudman helped constrain spending and deficits in the 1990s, it only applied to a narrow category of spending programs, which resulted largely in cuts in discretionary nondefense spending, including research, investment and education, while entitlement spending grew unabated. To be effective, new fiscal rules must be comprehensive and include all Federal spending programs except debt service costs. Also, the rules must set out clear guidelines that prevent the use of “creative accounting” loopholes.

Fiscal rules should be enacted immediately that set forth a target path for the primary budget deficit. Budget targets through Fiscal Year 2012 should not be materially different than current law projections in order to avoid concerns about any negative economic impact of near-term fiscal austerity. For subsequent years, the fiscal guidelines would require legislation that significantly cuts deficit spending and require reforms of future entitlement benefit structures. A balanced primary budget would be required by 2015 and a primary budget surplus of 3 percent by 2020 (measured from the CBO’s “alternative baseline”, these targets would require significant cuts in deficit spending). A long-run fiscal roadmap must also be established: based on longer-run projections of budget imbalances, legislation must be enacted by 2015 that would cut by half the projected budget gap in 2030.