E21 Manhattan Institute

ECONOMIC POLICIES FOR THE 21ST CENTURY

Sorting Out Monetary and Fiscal Policies

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Chairman Barr, Ranking Member Moore and Members of the Committee, I appreciate this opportunity to present my views on monetary and fiscal policies. Both have gone off-course. Excessively easy monetary policy, marked by a massive increase in the Federal Reserve's balance sheet and sustained negative real interest rates, has failed to stimulate faster economic growth, but has distorted financial behavior and involves sizeable risks.

Fiscal policies have resulted in an unhealthy rise in government debt, and projections of dramatic further increases involve incalculable risks. Monetary and fiscal policies interact in undesirable ways. The Fed's expanded scope of monetary policy has blurred the boundaries with fiscal and credit policies, and the ever-growing government debt may eventually impinge on the Fed and its independence.

A reset of monetary and fiscal policies is required. The Fed has begun to normalize monetary policy, so at this point, a shift in fiscal policy is much more pressing.

The Fed must continue to raise interest rates and begin unwinding its balance sheet, but be more aggressive than indicated in its current strategy, including eventually fully unwinding its holdings of mortgage-backed securities (MBS). A full normalization of monetary policy would benefit economic performance and improve financial health. Equally important, the Fed must acknowledge the limitations of monetary policy and step back from policy over-reach, including credit allocation and its excessive focus on short-term fine-tuning.

The longer-run projections of government debt are alarming, and must be taken seriously (see Chart 1). Congress must develop and implement a strategy that guarantees sound longer-run finances. This requires tough choices but the costs of inaction are rising. **Many acknowledge the risks of rising debt for future economic performance, but in reality the burdens of the government's finances are already affecting current economic performance and the government's allocation of national resources.** Witness how the persistent increases in entitlement programs and concerns about high government debt squeeze spending on infrastructure, research and development and other activities that would enhance economic performance. Under current laws, these budget constraints—at the Federal as well as those facing State and municipal governments—will only increase in severity.

Congress's fiscal agenda must be two-pronged. First, you must develop and enhance programs and initiatives that directly address the sources of undesired economic and labor market underperformance while restructuring and trimming spending programs that are ineffective and wasteful. Second, you must enact laws that phase in reforms of the entitlement programs over lengthy periods to constrain the projected growth of future spending in a fair and honest way, protecting lower-income retirees while providing sufficient time for older workers to plan for retirement.

I fully understand the frustrations stemming from the under-performance of the economy in recent years—the sizeable pockets of persistently high unemployment and low wages facing many working-age people, and weak trends in business investment and productivity that underlie disappointingly slow growth. **We all want better performance. But the issue is how to achieve it.**

Neither the Fed's sustained monetary ease nor high deficit spending address structural challenges facing labor markets, business caution in expansion and investing, weak productivity and other

critical issues. This is particularly apparent with the unemployment rate at 4.4%, below standard estimates of full employment.

The reality is, monetary policy cannot create permanent jobs, improve educational attainment or skills, permanently reduce unemployment of the semi-skilled, or raise productivity or boost real wages. Rather, monetary policy is an aggregate demand tool. The major sources of underperformance involve structural challenges that are beyond the Fed's ability to address.

Yet in recent years, there has been excessive reliance on the Fed. All too frequently, analysts and observers opine "fiscal policy is dysfunctional so the Fed has to ease policy". This assumes that monetary policy and fiscal policy are two interchangeable levers.

They are not. **Monetary policy is not a substitute for fiscal policy.** Monetary policy controls interest rates and the amount of money in the economy, which influences aggregate demand and longer-run inflation.

Fiscal policy operates differently. Government spending programs and tax structures allocate national resources—for income support, national defense, health care, public goods like infrastructure and an array of other activities—and create incentives favoring certain activities while discouraging others. In a critical sense, the magnitude and mix of spending programs and the structure and details of tax policies—along with the magnitudes of deficit spending—reveal the nation's priorities set by fiscal policymakers. These allocations of national resources and how specific spending and tax provisions influence households and businesses are key inputs to economic performance, productivity and potential growth.

In recent decades the most pronounced change in the government budget is the rapid expansions of Social Security, Medicare and Medicaid. The objectives of these entitlements are laudable, and they are critical for government and society. However, the resulting dramatic rise in the share of government spending allocated to income support and health, along with the rising concerns about the rising debt, has squeezed spending on other programs, including those that enhance longer-run productive capacity.

Can these government programs be improved, made more efficient or modified in ways that maintain their objectives? Yes. Congress must cut through budget categorizations like "mandatory spending" and "discretionary spending programs" and identify ways to improve the efficiency of these programs while maintaining their intent.

Aside from monetary and fiscal policies, labor market performance and business decisions are affected by a growing web of economic and labor regulations imposed by the Federal, state and local governments. Private industries add to the list of regulatory requirements, including the expanding imposition of occupational certification requirements and other practices like "non-compete" job contracts. Certainly, while some of these government regulations and industry rules serve important roles, many constrain the mobility of a sizeable portion of the labor force, limit job opportunities and are very costly to the economy. Obviously, these are beyond the scope of monetary and fiscal policy.

I mention regulatory policies in the same breath as monetary and fiscal policies because each has unique economic effects. In order to improve performance and standards of living, we need to address the sources of the underperformance with the proper policy tools, rather than rely on standard monetary and fiscal stimulus that are unlikely to have desired outcomes.

The Fed's expanded scope. The Fed deserves credit for its quantitative easing (QE) in 2008-2009 that helped restore financial stability and end the deep recession. The paralysis in the mortgage and short-term funding markets was scary and truly a crisis. The Fed's aggressive interventions and asset purchases, including MBS and its "bailout" of AIG, directly involved the Fed in credit allocation and fiscal policy. At the time, Fed Chairman Ben Bernanke explicitly identified them as temporary emergency measures, and stated that the Fed would exit them on a timely basis.

But the efficacy of the Fed's dramatic expansion of its large-scale asset purchase programs (LSAPs) and targeting the Fed funds rate below inflation well after the economy had achieved sustainable growth and financial markets had stabilized is questionable, and the expanded scope of monetary policy involves large risks (see Chart 2).

Financial markets have been stimulated, but the economy has been largely unresponsive: nominal GDP has not accelerated, and economic growth has been sub-normal (see Chart 3). Business investment has been disappointing despite the Fed's successful efforts to lower the real costs of capital. Productivity gains have been weak and estimates of potential growth have been reduced significantly. Labor markets have clearly improved, but large pockets of under-employment persist.

Non-monetary factors, including government tax and regulatory policies, have hampered credit growth and economic performance. In banking, the burdensome micro regulations imposed by Dodd-Frank and the Fed's stress tests have deterred bank lending. The Fed's low rates and forward guidance aimed at keeping bond yields low have dampened expectations.

As a result, monetary policy channels have been clogged so the high-powered money created by the Fed's large-scale asset purchases (LSAPs) remains as excess reserves on big bank balance sheets and has not been put to work in the economy. In the nonfinancial sector, the array of taxes and regulatory burdens and mandated expenses imposed by Federal, state and local governments have led businesses to raise their hurdle rates for investment projects. Many job-creating expansion plans have been scuttled.

The Fed takes far too much credit for the sustained economic expansion and labor market improvement of recent years. In reality, without the sustained aggressive monetary ease, the economy would have continued to expand and jobs would have increased. History shows clearly that economic performance has not been harmed when the Fed has normalized interest rates following a period of monetary ease. Not surprisingly, the three Fed rate hikes since December 2015 have had no material impact on economic performance.

The failure of nominal GDP to accelerate in response to the Fed's unprecedented monetary ease has been the critical reason why wage increases have remained modest and inflation has remained below the Fed's 2% target. The slow (and non-accelerating) growth of aggregate product demand has constrained business pricing power and at the same time has influenced wage-setting behavior. In every prior expansion in which the unemployment rate fell below standard estimates of its natural rate ("full employment"), wages accelerated briskly.

During this expansion, the slower growth in aggregate product demand has been a key constraining factor. Inflation additionally has been constrained by lower prices of select goods and services stemming from technological innovations. Most notably, the PCE deflator for durable goods has fallen persistently

since the mid-1990s. These innovations have increased consumer purchasing power and benefited the economy. It is ironic that the inability of aggressive monetary ease to stimulate aggregate demand has allowed the Fed to be complacent about normalizing policy without violating its dual mandate.

The Fed's historical tendency to fine-tune the economy and financial markets has been accentuated. The Fed's LSAPs, reinvestment policy and hesitancy to normalize policy have been heavily influenced by short-term fluctuations in the economy, global and domestic markets, the labor force participation rate and wages. These are beyond the Fed's mandate and well beyond the scope of monetary policy. Such short-term focus historically has led to policy mistakes.

The Fed's balance sheet. As a result, the Fed maintains a balance sheet of $4.5trn, including $2.5trn of US Treasury securities of various maturities and $1.8trn of MBS, primarily with long maturities (see Chart 4). The Fed is now the largest holder of each (17% of outstanding publicly-held Federal debt and 12% of MBS outstanding). Prior to the financial crisis, the Fed's balance sheet was roughly $850bn, comprised nearly entirely of short-term Treasury and other liquid securities.

The Fed finances these assets in large part by borrowing over $2trn in short-duration notes from the banking system, and accounts for these liabilities as excess reserves on its balance sheet. An estimated 25-33% of excess reserves are held in US branches of foreign banks. In October 2008, the Fed adopted a policy to pay interest on excess reserves (IOER) equal to the top band of the Fed funds target, with the intention of providing a floor for propping up the effective Fed funds rate. With the Fed's June rate increase, it now pays 1.25% on IOER.

The Fed's current balance sheet strategy is to gradually and passively unwind a fairly even portion of its Treasury and MBS holdings with an aim of maintaining a large buffer of excess reserves. This implies a shift from pre-financial crisis operating procedures. The Fed is very concerned about adverse implications for financial markets and mortgage rates in particular and has built an argument that maintaining a large amount of excess reserves going forward would be beneficial to financial markets and the Fed's conduct of monetary policy.

But the Fed's holdings of MBS are inappropriate, directly involving monetary policy in credit allocation, and should be totally unwound. The Fed's MBS holdings effectively favor mortgage credit over other types of credit. While the initial MBS purchases during the height of the financial crisis had a distinct purpose, continuing to hold MBS makes little sense. **This expanded scope of monetary policy is all the more irrational in light of the healthy growth in housing and high home prices.**

The Fed's intention to maintain a large buffer of excess reserves would require the Fed to continue to pay IOER and manage the effective Fed funds rate through a "floor system". I prefer a strategy of maintaining a smaller balance sheet that would involve less excess reserves in the banking system and rely on the market-based "corridor system" that was used through most of the Fed's history. Doing so would allow the Fed to lessen its exposure in the overnight reverse repo market. However, this operational preference is of less importance than the higher priorities of fully winding down the Fed's MBS holdings and reining in the scope of monetary policy.

Monetary influences on fiscal policy. The Fed's balance sheet, low policy rate, and forward guidance aimed at keeping bond yields low temporarily reduce budget deficits and the government's debt service

costs. The Fed effectively is operating a massive positive carry strategy by borrowing short and lending long. This will generate profits and reduce budget deficits as long as interest rates stay low. The Fed's remittances to the US Treasury reached a peak of $117bn in fiscal year 2015 and have receded as the Fed has hiked rates that has triggered an increase in IOER to banks. These large remittances to the Treasury have materially reduced recent budget deficits.

While this may sound good superficially, it involves sizeable risks—to current and future taxpayers—and entangles the Fed's monetary policy in the government's budget and fiscal policies in unhealthy ways. It also compromises the Fed's independence, a concern that should be taken seriously.

Congress seems to perceive that the Fed's policies aimed at stimulating the economy and lowering deficits and debt service costs are risk-free and permanent, when in fact they involve sizeable interest rate exposure. The Fed's remittances will fall as it normalizes its policy rate. More importantly, in light of the magnitude of Federal debt outstanding (currently $15trn and estimated by the Congressional Budget Office to rise to $27trn in 2027), budget deficits and debt service costs are very sensitive to interest rates. The CBO estimates that a one percentage point increase in interest rates from its baseline assumptions over the 10-year projection period would add $1.6trn to the budget deficit.

Such interest rate risk must be taken seriously. The Fed's forecasts of higher policy rates, sustained economic growth and a rise in inflation to 2% point toward higher bond yields, and prior experiences of positive carry strategies often end badly. Witness the failures of many private financial companies, as well as Fannie Mae and Freddie Mac, which required government bailouts. **The Fed's efforts to be more transparent should include a clear assessment of the government's budgetary risks of its sustained monetary ease.**

The suppressed deficits and debt service costs have eased pressure on Congress to address the growing budget imbalance. The Fed's profits remitted to the Treasury have also proved enticing to fiscal policymakers and encouraged undesirable budget practices.

In December 2015, Congress's enactment of the FAST Act to provide financing for transportation infrastructure relied on budgetary "sleight of hand" in which it redirected a small portion of the Fed's assets and some of its net profit into the Highway Trust Fund. The Fed was compromised but did not protest the way this budgetary procedure inappropriately used monetary policy for fiscal purposes. This episode sounds minor, but it illustrates the potential vulnerabilities of the Fed's expanded scope.

Fiscal policy influences on monetary policy. To date, fiscal considerations have not influenced the Fed's monetary policy deliberations. The debates about tax reform, the fiscal year 2018 government budget and potential snags relating to the debt ceiling add uncertainties that the Fed must consider, but they have been relatively low-level concerns. The projections of dramatically rising government debt, and the lack of impetus of fiscal policymakers to address the issue, raise the prospects that the government's finances may influence the Fed and impinge on monetary policy.

The bottom line is, sound monetary policy ultimately relies on sound government finances. In the extreme, unsustainably high government debt service burdens may dominate monetary policy and require the Fed to accommodate fiscal policy by reducing the real value of the debt or, in an extreme, by ensuring the government's solvency.

Such a prospect of fiscal dominance of monetary policy seems remote and far off. However, it may not be so distant, particularly if fiscal policymakers ignore the longer-term budget debt realities. Moreover, nobody really knows when the level of debt becomes “unsustainable” or when or how government finances may unhinge inflationary expectations.

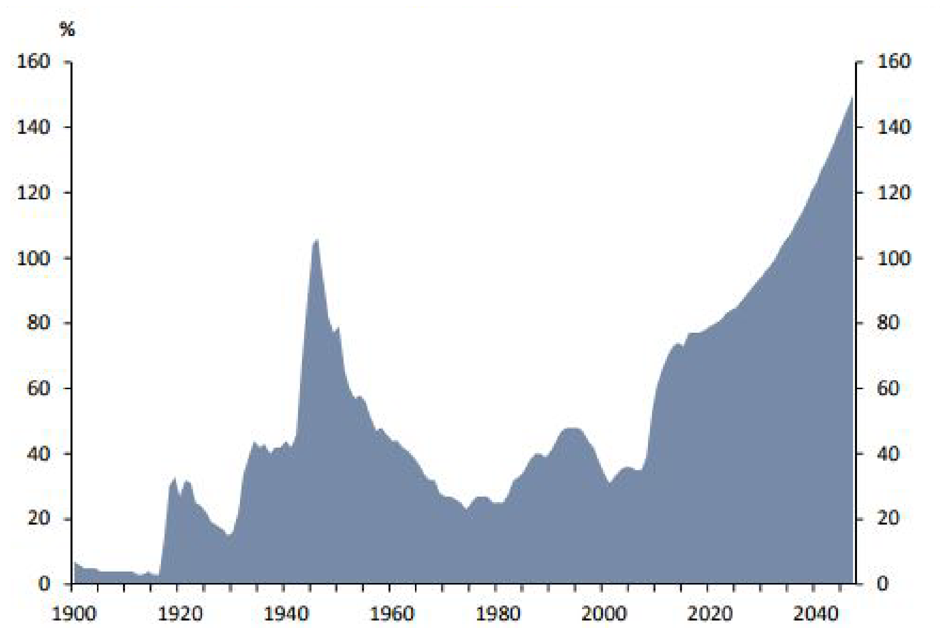
In this context, the current fiscal debate about tax policy should be focusing on reforms that increase productive capacity by reducing inefficiencies and distortions and improving the environment for economic expansion, rather than temporary fiscal stimulus that involves more deficit spending. This is particularly true with the economy entering its ninth consecutive year of expansion.

Congress faces several alternative fiscal policy paths. It may continue to avoid reforms of current spending programs and the tax structure. Economic growth would remain slow, large pockets of underperformance in labor markets and slow wage growth would persist, reliance on income support would mount and government programs would become increasingly strained, and government debt would continue to rise rapidly. Disappointing economic performance would be reinforced, and downside risks would rise.

Alternatively, Congress may develop and implement reforms of current spending programs, particularly the entitlements, improving their structures while maintaining their intent, and address the sources of the rising government debt, and reform and simplify the tax system, particularly corporate taxes. These efforts would lift sustainable economic growth, improve the productivity, wages and economic well-being of underperformers in labor markets, and ease burdens on income support systems and improve government finances. Future concerns are quickly becoming current realities. The time for policy action is now.

Chart 1:

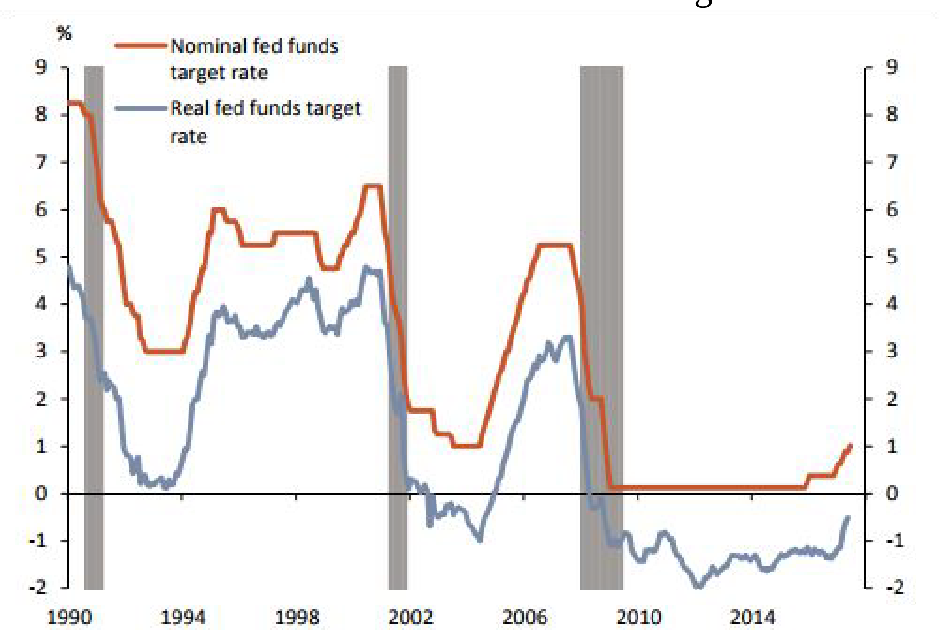
Federal Debt Held by the Public as a Percentage of GDP



Source: Congressional Budget Office

Chart 2:

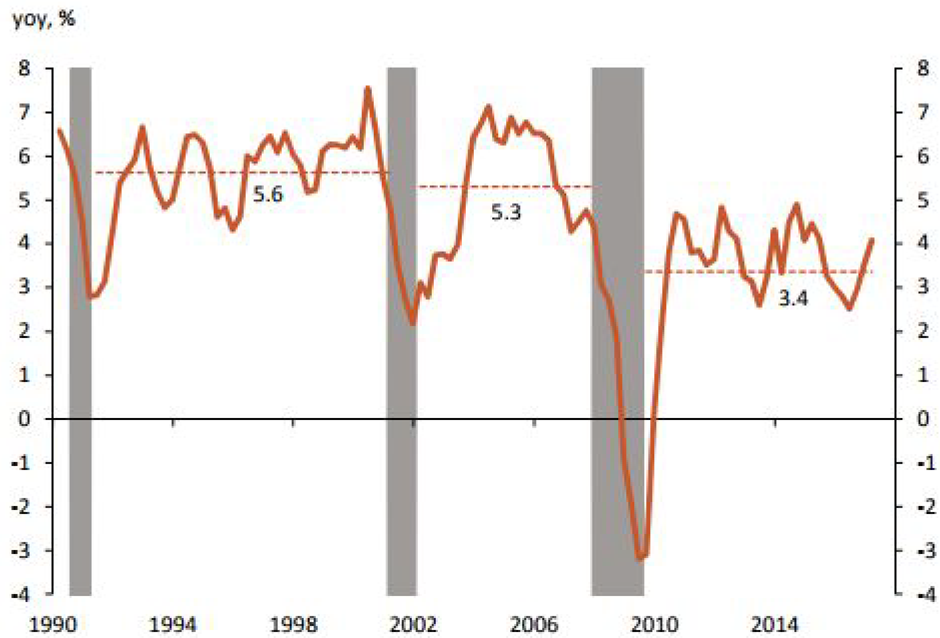
Nominal and Real Federal Funds Target Rate*



*Note: Real federal funds target rate deflated by core PCE inflation.
Source: Federal Reserve Board and Bureau of Economic Analysis

Chart 3:

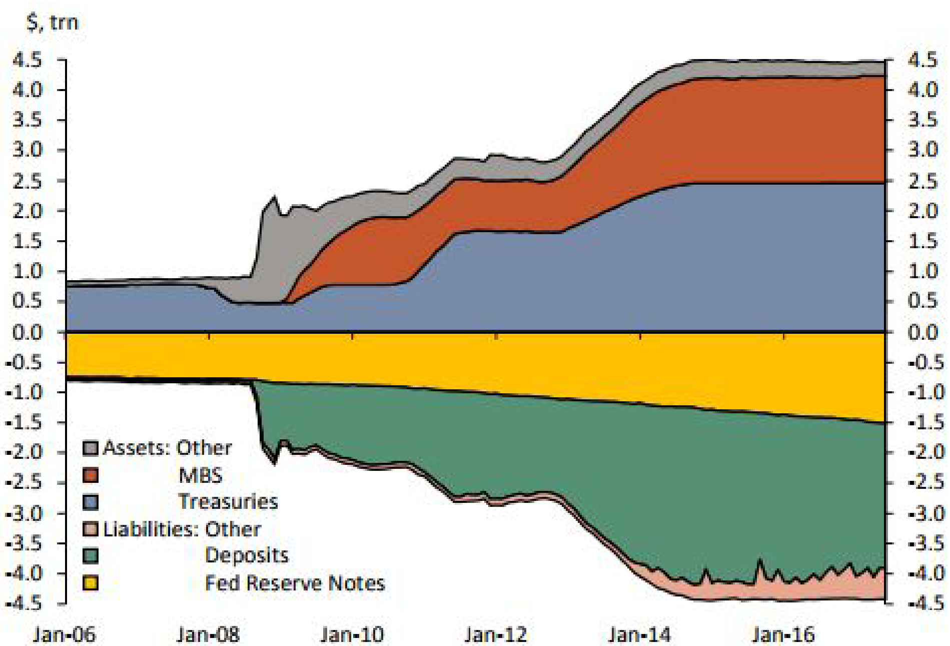
Maturity of Fed Holdings of US Treasuries (Share of Current UST Total)



Source: Federal Reserve Board

Chart 4:

Maturity of Fed Holdings of MBS



Source: Federal Reserve Board