Monetary Policy Independence Amid Fiscal Policy Deterioration

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Shadow Open Market Committee
March 26, 2010

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Monetary policy and fiscal policy serve different functions and have very different economic effects, but too frequently, their roles and effects are confused. Economic performance is best served when monetary and fiscal policy roles are clearly delineated. Now more than ever, with so many concerns about the economic recovery, jobs and mounting budget deficits, maintaining the Federal Reserve's independence in the conduct of monetary policy and re-establishing the optimal boundaries between monetary and fiscal policies is critically important to sustained healthy economic performance.

Financial crisis, deep recession and aggressive and expensive government policy responses have extended fiscal, credit and monetary policies well beyond their normal roles and significantly blurred their functional boundaries. Corrective actions are needed—to disentangle their roles, normalize monetary policy and get fiscal policy back on a sustainable path that shrinks the budget imbalance and promotes economic growth and permanent jobs.

Historically, international evidence strongly indicates that independent central banks generate healthier economic performance and lower inflation than do central banks with lesser degrees of independence. The importance of a monetary authority independent of outside pressures becomes paramount when a government's public finances have deteriorated. US budget deficits have soared, and public confidence in government to successfully address critical fiscal issues has ebbed. Yet the Fed's independence is now being challenged.

Threats to the Fed's independence come at exactly the wrong time. Normalizing monetary policy on a timely basis—hiking interest rates and reducing its balance sheet—will be difficult, and this difficulty may be compounded by the disarray of fiscal policy and soaring government debt, the Fed's current involvement in fiscal and credit activities, and political pressures in Washington stemming from high unemployment. The loss of fiscal policy credibility and growing public discontent with the government's finances heighten the importance of maintaining central bank independence and credibility. The Fed must remain independent in order to move monetary policy toward its long-run objectives, and to provide a critically important anchor for fiscal policymakers to tackle the pressing budget issues in an economically responsible way.

The importance of maintaining central bank independence is highlighted by the European Central Bank's critical role in Europe. The ECB's steady, hard-money credibility has limited the negative economic and financial reverberations from Greece's financial crisis. In sharp contrast, Argentina's government recently tried to force the Central Bank of Argentina to use its balance sheet reserves to service government debt, and facing opposition, it fired the central bank's president. The bank's diminished credibility involves large potential future costs.

Several aspects of the US government's deficit spending and projections of a doubling of debt relative to GDP deserve attention. Firstly, beneath the surface of the unified cash flow budget, the long-run budget imbalance has been deteriorating for decades, as the unfunded liabilities of the retirement and entitlement programs have grown unchecked. The deep recession of 2008-2009 and the government's recent aggressive fiscal responses have added significantly to higher current and future deficits. The costs of debt service will compound, particularly as interest rates normalize, and some spending and tax programs that add to the deficit are being made permanent. Certainly, budget deficits will recede from their staggeringly high 2009-2010 levels, but most disturbingly, they are projected to remain at unsustainably high levels (in excess of 4.5 percent of GDP) even when the economy has returned to full employment.

For decades, it has been clear that ultimately reducing the long-run budget imbalance and achieving fiscal responsibility requires coming to grips with the retirement and entitlement programs. As the government's unfunded liabilities have soared above $50 trillion, it has also become increasingly clear that these programs' benefit structures must be modified: tax increases sufficient to arithmetically "close the gap" would damage economic performance and make the unfunded liabilities problem even worse. Despite repeated failures of fiscal policymakers to address these looming long-run problems, fiscal policy credibility has ebbed and flowed with cyclical fluctuations in the cash-flow deficits. Recessions and high cash-flow deficits heightened public concerns, but when deficits shrank with strong economic growth, fiscal credibility rose, even when the government's overall budget imbalance continued to deteriorate (witness the 1990s, when strong growth, the post cold war defense spending downsizing, and the stock market bubble generated cash-flow surpluses).

The requirement of addressing the retirement and entitlement programs not only remains, but becomes paramount. As the post-war baby boom children begin to retire, strong economic

growth alone will not be sufficient to reduce large and persistent budget deficits. The Administration and Congress continue to seem in denial of this obvious trend. The new Presidential Commission must acknowledge it, and force a constructive plan of fiscal action.

Secondly, a rising share of the government's spending (and deficit spending) involves transfer payments whose basic function is to provide income support and redistribution that primarily fuel current consumption, while a shrinking share of outlays are allocated to investment, research and development and related activities that add to productive capacity. This allocation of national resources will slow long-run potential growth and raise debt service burdens on future generations. Recent fiscal initiatives have accentuated this trend. In this regard, too much attention is paid to the aggregate cash flow budget deficit numbers, and too little to how the government's programs allocate national resources, and how they impact longer-run economic performance.

Thirdly, the broad range of the recent crisis-response fiscal policies—including traditional countercyclical stimulus programs, financial bailouts and extraordinary credit measures, the effective nationalization of Fannie Mae and Freddie Mac, and government equity ownership in a large commercial bank and insurance company—has dramatically expanded the role of government in the economy.

Congress and the Administration continue to pursue extraordinary steps to stimulate the economy and job creation and elicit the Fed's help. Members of Congress ask Fed Chairman Bernanke what the Fed is doing about creating jobs, and express concerns about housing and the construction industry. These are typical cyclical concerns, but they must be kept in perspective through the clear distinction between the different roles of fiscal and monetary policy. The Fed must pursue its dual mandate and not be forced to address short-run concerns beyond its capability. Most importantly, current concerns must not spill over into pressures to monetize the fiscal deficit. This possibility may seem far-fetched and remote, but it is obvious that the rapid growth in government spending must be paid for one way or another. The notion of using monetary policy as a "release valve" for unmanaged fiscal policy must be rejected firmly and not allowed to gain traction. It has happened in other countries, even recently—for example, Argentina—with significant and long-lasting negative effects.

As the Fed begins the operational aspects of its exit policy amid blurred lines of functions and responsibilities, and Washington's pressing problems and politics, it is critically important to emphasize that monetary and fiscal policies have different economic effects. The Fed conducts monetary policy with the goal of achieving its dual mandate of low inflation and low unemployment that was established by the Congress. It does so by generating sufficiently low inflation and inflationary expectations so that the economy can grow in line with underlying capacity, generating maximum sustainable employment. Monetary policy is not capable of permanently increasing productivity or output, and cannot by itself generate jobs. Instead, it works by creating the optimal environment for these developments—price stability. Excess demand relative to productive capacity generates inflation while insufficient demand leads to declining prices.

Fiscal policy involves spending and tax programs that allocate national resources and influence the composition of economic performance—the composition of economic activity among different sectors as well as intergenerational growth patterns—through their effects on spending, saving and investment decisions. The allocative effects of tax and spending programs have marked impacts on sustainable potential economic growth and permanent job creation. Countercyclical fiscal policies are designed to temporarily smooth out business fluctuations by boosting economic activity and providing job support during downturns and dampening activity when the economy is perceived to be overheating. Unlike monetary policy, fiscal policy is not capable of generating a permanent shift in aggregate demand. But it affects labor market behavior, long-run job creation and the natural rate of unemployment.

Accordingly, "shifting the policy mix" (i.e., loosening monetary policy and tightening fiscal policy or vice versa) cannot be expected to generate the same economic outcome, and may result in unintended outcomes. Presently, monetary policy must not respond to or attempt to offset fiscal policies—either as a countercyclical tool or in the face of unprecedented deficit spending.

Both fiscal and monetary policies are on unsustainable paths, and in both cases the potential costs of current policies and the timing of those costs are uncertain. When will the dramatic increases in deficit spending and debt affect interest rates and economic performance? How does the soaring government debt of other rich industrialized nations affect the outcome? When will

the Fed's unprecedented quantitative easing push up inflationary expectations or generate higher inflation? No one knows for sure.

The Fed's expansive monetary policy—marked by the dramatic run up in bank reserves and near-zero interest rates—poses an intermediate inflation threat, but inflation pressures are not imminent. Weak demand has eased pricing pressures and elicited lower production costs. Nominal GDP declined significantly for 3 consecutive quarters, its longest and steepest fall since the 1930s, generating slack demand relative to productive capacity. Unit labor costs fell an estimated 4.7% in 2009 as businesses boosted labor productivity—it rose 5.8 percent--and constrained wages. This has increased profit margins and reduced price pressures. Core inflation has drifted down below 1.5%.

Although inflation is likely to remain low in 2010, caution is warranted. Inflationary expectations are about 2.5 percent, and any material rise could influence wage and price setting behavior. Secondly, historically, a large measured GDP Gap like the current situation has not always guaranteed low inflation. Aggregate demand is recovering—nominal GDP rose 4.4 percent annualized in the second half of 2009, and likely will maintain that pace in 2010. This could generate inflation pressures, despite current estimates of significant economic slack. The Fed must monitor and constrain inflationary expectations.

The Fed's crisis management policies have inserted monetary policy into the realm of fiscal policy, most notably through its massive purchases of mortgage backed securities and GSE debt, direct subsidies in the case of Bear Stearns and sizeable loans to AIG. The financial crisis has ended and the Fed must remove itself from those activities.

The Fed's balance sheet has more than doubled, from $900 billion to nearly $2.3 trillion, as Treasury holdings have been dwarfed by long-maturity MBS and GSE debt. The objective of the Fed's unique quantitative easing—what Fed Chairman Bernanke has termed "credit (or financial) easing"—has been to reduce mortgage rates as a means of ameliorating the distressed mortgage market and reinvigorating housing activity. Although quantitative easing was an appropriate response to the zero bound on nominal interest rates, the Fed's credit easing has entangled it in the government's wide array of housing policies and credit allocation programs. This is well beyond the Fed's legal dual mandate, and direct involvement in these programs

brings the Fed uncomfortably vulnerable to Congressional political pressure. This is particularly true since the government has no game plan for what to do with Fannie Mae, Freddie Mac, the Federal Housing Administration, or housing policy in general.

The Fed has indicated that simply allowing existing mortgage-related and Treasury securities to roll off without reinvestment would reduce its balance sheet by an estimated $340 billion (of a $2.3 trillion total) through year-end 2011. But if bank lending increases and economic growth accelerates such that money multipliers begin rising, such passive balance sheet runoff may be insufficient. Proactive monetary policies will be required.

Besides raising rates and shrinking its balance sheet, normalizing monetary policy requires that the Fed unwind its holdings of credit assets, including its massive holdings of MBS, GSE debt and exposure to AIG assets. Credit subsidies should be reflected on the Treasury's general ledger, not the Fed's balance sheet. Fannie Mae and Freddie Mac are under conservatorship and largely owned by the Treasury, and their operations belong on the government's unified budget. The Fed should swap these credit assets with the Treasury for US Treasury securities. This would not affect the size of the Fed's balance sheet or the thrust of monetary policy, but would help re-establish the functional boundaries between monetary and fiscal policies. AIG's asset sales will help finance a partial unwind of the Fed's exposure. The Fed should swap its remaining AIG assets with the Treasury for Treasury securities. The Treasury should be amenable to these swaps: it would not affect mortgage markets or the government's support of the credit markets, and it would improve the Fed's flexibility to normalize monetary policy and thus heighten its credibility.

The Fed has not indicated how high interest rates will have to rise as it normalizes monetary policy. The real Federal funds rate is now negative, even though real GDP has grown for 3 consecutive quarters. As the economic recovery matures, rising rates will not sidetrack economic expansion, whereas unduly delaying the normalization of real rates would generate problems for the future.

The Fed's best course of action is to conduct monetary policy independent of fiscal policy and maintain credibility. The Fed's credibility, which will constrain inflation risk premia in bond yields, is critically important to fiscal policymakers as they undertake measures toward long-run

fiscal responsibility. The Fed should continue to provide only the broadest advice on fiscal issues and avoid specific suggestions; that is beyond the bounds of its mandate.