# Monetary and Fiscal Policies Following Crisis Management

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In Fall 2008, financial markets convulsed with shock, and the recession deepened abruptly and quickly spread globally. Monetary and fiscal policies, already aggressively addressing the recession and financial strains, shifted into crisis mode, and an unprecedented set of crisis management policies were quickly implemented. Since that time, financial markets have stabilized and the economy has adjusted, benefiting primarily from the Federal Reserve's extraordinary liquidity provisions. The recession has ended, and economic recovery has begun. Policymakers must now put into motion strategies that will unwind their crisis management and re-establish sustainable policies, consistent with long-run macroeconomic objectives.

So far, the Fed has acknowledged that it must exit from currently unsustainable monetary policies and raise interest rates. Its lack of full transparency stems from its own uncertainty regarding strategic details and timing. But the Fed knows its ultimate objectives: to withdraw excess liquidity, shrink its bloated balance sheet and raise interest rates consistent with the Fed's dual mandate of low inflation and unemployment. In contrast, fiscal policymakers—the Administration and Congress—have shown no indication that any adjustments to the current thrust of fiscal policy are needed. Certainly, current fiscal policymakers cannot be blamed for the mounting unfunded liabilities of the entitlement programs. But new, large deficit spending initiatives defy the widely held assessment that the current thrust of policy is unsustainable and damaging to longer-run economic performance. Long-run fiscal strategies, based on sound analysis and transparency, and untainted by short-run political considerations, are needed to re-establish realistic and credible policies.

## The Fed's Agenda

The rapid runoff of short-term securities from the Fed's balance sheet and the dramatic narrowing in Libor spreads confirm the success of the Fed's post-Lehman crisis management and financial stabilization. The Fed's open market purchases of mortgages have lowered mortgage rates, helping to support demand for housing and generate a surge in mortgage refinancing that has improved household balance sheets. However, the Fed's quantitative easing has dramatically expanded reserves and the monetary base, lengthened the duration of the Fed's balance sheet and entwined the Fed in credit allocation. The Fed must set out an exit strategy, including ending its participation in other crisis management policies, most notably the PPIP.

Even if the dramatic build up in the monetary base does not result in higher inflation in the near term—and I do not believe it will, as wage and price pressures are likely to be temporarily constrained by weak aggregate demand and slack in the economy—the Fed's policies involve other costs. The US dollar is falling, reflecting lower real expected rates of return on US capital, which lowers standards of living. And the Fed's involvement in the credit allocation process is a highly undesirable activity under normal conditions.

The Fed's exit strategy should involve several aspects. The Fed should announce that its purchases of US Treasury securities will not be renewed or extended. They no longer serve any purpose and only add to excess reserves. The Fed should announce its intention to reduce the size of its mortgage purchase program. Any resulting back up in mortgage rates would be moderate and would not sidetrack the rebound in housing. Home prices are stabilizing and liquidity has returned to the mortgage market; extending the Fed's purchases increases the difficulty of the Fed's exit and eventually would drive bond yields even higher.

The Fed should turn the PPIP program over to the US Treasury. If the Treasury sees the need for the government-financed leveraged purchases of distressed assets, it should run the program, and the PPIP operations should be transparently included in the government's unified budget, rather than involving the Fed in credit allocation and further bloating its balance sheet.

Exiting will involve both open market sales of the Fed's large holdings of Treasuries and MBS, and more traditional short-term operations that normalize the Fed's target Federal funds rate. In addition, adjusting the rate of interest paid on reserves likely will be an actively-used tool in managing money market pressures during the upcoming monetary policy firming. The relative timing of interest rate hikes and outright security sales to reverse the still-ongoing quantitative easing will be a key component of the Fed's exit strategy.

The Fed should begin its exit on a timely basis. In past recoveries, Fed concerns about the sustainability of the recovery have frequently led it to wait too long before hiking rates. In light of current monetary policy, repeating that mistake could potentially be very costly. The Fed must resist political pressures not to exit and hike rates.

The Fed has stated that its policies are conditional on economic and market conditions. Its present view is the economy will recover gradually, similar to its outlook around prior recession troughs, and close to the consensus of private sector economists. As is fashionable around recession troughs, some private sector forecasters predict a double-dip recession. While the media loves the notion, it has rarely occurred; presently, the probability of a double-dip recession is very low. With few notable exceptions generated by economic policy mistakes, once recoveries begin, boosted by monetary and fiscal stimulus, they typically continue and gather momentum. The double-dip recession in 1982 stemmed from extreme Fed tightening—the Fed hiked the Federal funds rate over 19 percent in 1981—and very high real interest rates choked off recovery. The 1937 recession that culminated the Great Depression was generated by sizeable tax hikes and the Fed's boost in reserve requirements.

Historically, the deeper is the US recession (measured by decline in real GDP), the faster the economic recovery. The gradual recovery outlook reflects concerns about the high level of household debt and the need for higher personal saving, and international experience suggesting that recovery from financial crisis is slow. But the US's unprecedented monetary and fiscal stimulus and its relatively quick stability following financial shock may shorten the normal lags. Real GDP grew at an estimated annualized 3.5 to 4 percent pace in 2009Q3.

At early stages of economic recovery, there are always concerns that a rise in rates will sidetrack the recovery. Within reason, and with notable exceptions, rising rates do not inhibit sustained rebounds; rates rise naturally with accelerating economic growth. Housing has begun to rebound. New and existing home sales have risen 30 percent and 17 percent, respectively, from their January 2009 troughs, and new single-unit housing starts have risen 38 percent from their lows. Mortgage rates would rise if the Fed ended its open market purchases of mortgages, but not sufficiently to sidetrack continued recovery in housing. Consumer spending has increased modestly in the first 3 quarters of 2009. Clearly, consumers need to save more and reduce debt, which is likely to constrain consumption growth. But extending the Fed's quantitative easing and delaying rate increases as the economy recovers would have little impact on the overall path of consumption.

Successful exit from crisis management policies requires clear guidance to financial markets. Earlier this decade, the Bank of Japan clearly and repeatedly stated that it would end its quantitative easing when the year-over-year CPI turned positive; when it did, the BoJ ended its open market purchases without upsetting financial markets. The Fed must also pre-announce its exit strategy conditional on easy-to-understand benchmarks. Above all, the Fed must establish an exit policy based on monetary and macroeconomic objectives, and not allow its decisions to be influenced by short-run politics, the debate about financial market regulation, or fiscal policy.

**Fiscal Policy: The Wrong Path**

The outlook for fiscal policy is significantly more disturbing than monetary policy: the fiscal policy responses to the crisis were poorly designed, unfocused and wasteful, yet policymakers mistakenly overstate their effectiveness and confuse them with the stabilizing influences of the Fed's emergency alternative liquidity provisions and quantitative easing; and, importantly, fiscal policymakers presently indicate no recognition that an exit from the current thrust of policy is needed, even though it is widely acknowledged that current fiscal policy is unsustainable. The potential harm to future economic performance is sufficiently large that a strategic corrective course of action is necessary.

Besides the natural tendency to be driven by short-term considerations, fiscal policy makers seem to be relying on "wishful thinking exit policy", hoping that long-run sustainable economic growth will exceed expectations (and generate outsized tax receipts); that foreigners will readily purchase the same sizeable portion of US Treasury bonds as they have in the past; that the widely understood mounting costs of the mandatory entitlement programs (Social Security, Medicare and Medicaid) will somehow dissipate; and that taxes may be raised sufficiently (on a minority of the electorate) to close the financing gap without harming economic performance. Unfortunately, the probability of these "ifs" materializing is extremely low, and wishful thinking is not a viable strategy.

The economic dangers of the government's mounting long-run unfunded liabilities stemming from the entitlement programs have been a long-standing concern. A generation of Administrations and Congresses have effectively ignored the problem or failed to agree on needed changes.

The current Administration and Congress are not to blame for earlier policy failures, but the recent thrust of fiscal policies—countercyclical fiscal stimulus, TARP, the American Recovery and Reinvestment Act of 2009, and the tax and spending initiatives in the Fiscal Year 2010 Budget—and the deep recession have greatly accentuated the magnitude of deficit spending and government debt.

The Congressional Budget Office's latest budget estimates are truly alarming, and provide a clear warning signal. Its baseline projections estimate that budget deficits will remain above 3 percent throughout a 10-year projection period, ***even when the economy***

***is operating at full employment,*** but warns that in reality, deficits likely will be far higher. And these projections exclude the costs of pending health care legislation. In the CBO baseline, government spending will remain above 23 percent of GDP, well in excess of its historic norm, reflecting a more than doubling of net interest costs, due to financing the recession and countercyclical responses, plus ***permanent*** budget impacts of recent tax and spending legislation.

But the CBO emphasizes that baseline projections are not realistic: they presume the Bush tax cuts of 2001-2003 expire, the temporary AMT "fix-it" is not extended and future annual appropriations remain constant in real terms, all of which are unlikely. ***Simply assuming an extension of the tax reductions for low and middle income households—which the Obama Administration proposes and Congress supports—and extending the ATM fix raises the structural deficit, at full employment, to approximately 5 percent of GDP.***

***Most striking is that these projected deficits at full employment are a larger share of GDP than deficits in almost all prior recessions.*** What used to be cyclical budget shortfalls during recessions become permanent, even with healthy economic performance and low unemployment—assuming such performance is achievable with such permanent budget problems. These projections reflect the cumulative effects of the mounting costs of the entitlement programs, the costs of the deep recession and the aggressive fiscal policies of the Obama Administration. Thus, publicly-held government debt likely will rise far higher than the CBO's 62 percent of GDP in the CBO's constrained baseline, and likely reach 80 percent, double its 2008 level.

A critical economic problem is that the mounting debt exerts a financial burden on future generations of taxpayers while the spending and tax programs contributing to the rising debt primarily support current consumption and will have little if any positive impacts on productive capacity or potential growth. This weighs on future economic performance and financial burdens. In the current global context, the US needs to produce and export more, consume less and save more; the government's fiscal policies are strikingly inconsistent with those needs.

Some of the countercyclical stimulus provisions of 2008-2009 were one-time in nature, contributing to a temporary bulge in government spending (or lower tax receipts), and raising long-term debt service. Other provisions have more permanent impacts on spending and tax receipts. ***Compared to the relatively efficiently focused crisis-management monetary policy, in general the fiscal policy initiatives have been poorly designed or miss opportunities. Consequently, some key initiatives have not achieved their intended impact—but add to the government's financial burdens.***

Some stand out. As expected, lump-sum transfer payments have been primarily saved: President Bush's $100 billion "rebate" in 2008 and Obama's temporary payment programs (i.e., the $250 to each Social Security and Railroad Retirement recipient) largely failed to boost short-run consumption and effectively substituted government debt for private debt. The sizeable Federal grants to states had virtually no stimulative impact—but allowed states to postpone or avoid taking steps that would increase efficiency and productive capacity.

Obama's temporary tax reductions rather than permanent cuts in marginal tax rates for lower and middle-income households also ignored lessons from history and missed an opportunity to stimulate longer-run growth. The spending on infrastructure was a relatively small share of the countercyclical deficit spending and will be stretched out over many years. Moreover, the choice of many of these infrastructure projects has been influenced by local politics and they contribute little to productive capacity.

As is typically the case, some new programs initiated by the American Recovery and Reinvestment Act of 2009 (under the umbrella of "countercyclical fiscal stimulus") will be extended and become part of future 'baseline' budgets.

The Obama Administration's Fiscal Year 2010 budget proposes extending most of the provisions of the Bush tax cuts for low and middle income households, increasing Medicare outlays and raising discretionary spending on a variety of annually appropriated programs. It also proposes higher taxes on capital (dividends and capital gains) and high income earners beginning in 2011. The higher personal income tax rates would affect small entrepreneurs (Subchapter S corporations), traditionally a major source of job creation.

The Congress has not voted to enact the President's budget proposals, but these initiatives remain high priorities for the Administration.

Pending legislation that would expand medical insurance coverage, however well-intended, would likely allocate more national resources toward medical care, regardless of how it is financed or its deficit impact. All leading proposals involve government subsidies that would increase demand for medical services, but largely lack provisions that would commensurately improve efficiencies in the provision of medical care. Without such supply efficiencies, medical care would rise as a share of GDP, ultimately squeezing the growth of non-medical private household and business consumption and investment. The expanded insurance coverage would be financed by modest efficiencies and cost saving, higher taxes, fees to businesses and government borrowing. Whether higher taxes and fees on business adversely affect US research and development in cutting-edge medical services technology is uncertain, depending on specific provisions.

Importantly, the high costs of recent (and expected) fiscal actions come just as the US approaches the precipice of the massive financing needs of Social Security, Medicare and the other retirement programs. ***As the Baby Boomers retire, the widely anticipated "long-run" unfunded liabilities of these programs become current obligations on the government's unified cash-flow budget; as things stand, these outlays will be financed by issuing bonds.*** Far from fixing these long-festering problems, the thrust of fiscal policy is adding significantly to the budget gap, and will push it well beyond what is sustainable or healthy. In these circumstances, is it appropriate to wait to see what unfolds or proactively take preventive steps? I strongly prefer the latter.

Do such deficits and mounting debt “test the limits”? Who will buy the US Treasury bonds? What will be the economic costs? What are the remedies?

No one knows for sure the limits of the rise in US government debt—if, when and by how much it will harm economic growth and future standards of living—but the dramatic surge in deficit spending and debt comes at a bad time. The US Treasury will be issuing approximately $1.4 trillion in debt in each of the next two years, and conservative estimates project that the US publicly-held debt will double, rising above $14 trillion through 2019, and also double as a percent of GDP.

In recent years, China and other capital exporting nations have purchased well over half of all US Treasuries issued, but recently their demand for US dollar-denominated assets has diminished, and China, Russia and others have expressed concerns about the weaker US dollar and US macroeconomic policies. Many of these countries also will have less excess savings to export, as they increase domestic spending and invest more in non-US dollar denominated assets. China recently has reduced its purchases of US Treasury securities and shrunk its net holdings. The US Treasury’s massive bond issuance likely will contribute to higher interest rates and/or a lower US dollar, although the timing and potential magnitudes are highly uncertain.

Similarly, the impact on long-run sustainable growth of the dramatic rise in debt, the allocation of national resources toward current income rather than production-enhancing investments, and supply constraints imposed by the changing tax structure is negative, but of uncertain magnitude.

The budgetary and economic impacts of fiscal policy, combined with international economic and financial realities, pose a clear choice: are we willing to accept slower long-run economic growth—and slower improvement in future standards of living—as the inevitable cost of current policies? Elected officials must choose. Redirecting fiscal policy requires hard decisions and a long-run vision, as any successful resolution necessarily involves restructuring the entitlement programs—Social Security, Medicare and Medicaid—to constrain their spiraling costs in a fair and equitable way. All other spending programs pale in significance, and the magnitude of tax increases required to close the long-run budget gap would be sufficiently large to damage economic activity and push the goal of fiscal sustainability even farther away. The public must be aware of these intergenerational realities.