Guidelines for Global Economic Policymaking

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Economic policy is at a crossroads. Extraordinary actions were taken in extraordinary times. The worst feared outcomes have been avoided. While we have not yet won the war and we are not yet ready to declare "mission accomplished," policymakers must be prepared to make sure that we don't lose the peace. Indeed, laying the groundwork for winning the peace is the most crucial public policy issue for successfully bringing to a close the Great Recession.

Let's begin by asking where policy stands with regards to the question of the global macroeconomy? Policymakers and pundits throughout the world have commented on global imbalances. China saves too much. So does much of the rest of Asia. The U.S. saves too little. Sovereign wealth funds have too many resources. The yen is too strong. The Chinese currency is too weak. Can we all beggar thy neighbor? International macroeconomic adjustments are notoriously slow. Global macroeconomic relationships are unreliable. The list goes on.

Here is, however, what these observations miss: countries that adopt sound domestic policies typically have fewer complaints about their economic circumstances and long run performances. History teaches us that prosperity is homegrown, not imported nor exported. Policymakers should focus their attention and expertise on conducting domestic policies that support long run economic growth and stability. The bumper sticker should read, *"Think Globally, Make Good Policies Locally."* Unfortunately, there is limited evidence that the latter are in place.

Monetary policy is a good starting point for considering how to win the peace. Policymakers should begin by establishing a credible and sustainable long run monetary policy. To accomplish this, central banks need to do at least three things. First, announce a credible inflation target and stick to it. Second, a central bank should provide a clear and comprehensive policy guideline of its lender of last resort policy. A central bank should be able to post on its website the answers to the following questions: When will the central bank lend freely to the market? When will and under what circumstances will the central bank make loans to individual firms? What lending terms will the central bank require for collateral and interest rates? Central banks need to take the guesswork out of policy, both in good times and in bad.

Finally, central banks need to provide an explanation for how monetary policy will be systematically pursued in an environment of price stability, when short term policy rates are often near zero. Currently, monetary policy has been "*Turning Japanese*" among most major central banks. In response to the financial crisis, central banks' targeted overnight interest rates have approached the zero bound, and they have turned to balance sheet expansions and purchases of atypical assets – private assets, long term sovereign debt, and mortgage backed securities – to further their liquidity expansions. In undertaking these balance sheet expansions in a time of crisis, central banks assumed their function as a lender of last resort. They created unprecedented levels of liquidity to ease the financial fear and to lessen the steep declines in credit creation. Their actions placed a floor under asset prices and elevated the prices for bonds.

While we are no longer facing the immediacy of the financial crisis, we are saddled with its legacy. Clearly, the operational and policy implications of the scale and composition of a central bank's balance sheet are rapidly shifting. Are we headed in the right direction? No. At its meeting on August 10, 2010, the Federal Open Market Committee (FOMC) decided to maintain the size of its balance sheet and to reinvest maturing mortgage backed securities into long term Treasury bonds. This position was reiterated at their September 21st meeting, and now prominent FOMC members have discussed undertaking further quantitative easing because, in the words of Chairman Bernanke, "additional purchases have the ability to ease financial conditions."[1]

Not to be outdone, the Presidents of the Federal Reserve Banks of New York and Chicago have recently called for additional asset purchases to help spur the economy.[2] They suggest that the Fed should purchase half a trillion dollars or more of U.S. long term Treasury bonds. The reasons put forth are that real GDP growth and credit growth are soft, the current rate of inflation has recently fallen below the Federal Reserve's implicit target of 1.5% to 2.0%, and the unemployment rate is stubbornly high. More surprisingly, these officials have indicated that the FOMC may need to generate an inflation rate above its implied target for a time in order to offset the effects of the disinflation and the zero bound on the federal funds rate.

This new presumed stance by the FOMC is unduly aggressive, risky, unproven and misguided. These are not flattering descriptions of policy. First, let's look at the data. According to the most recent Bureau of Economic Analysis release from September 30th, 2010, real GDP for the second quarter of 2010 is 3.0%, measured as the percent change from the quarter a year before. Again, calculated from the quarter the year before, the PCE deflator is growing at 1.9%, and 1.5% excluding food and energy.[3] Indeed, these figures do not seem alarming in and of themselves.

To be fair, members of the FOMC would argue that they need to be aggressive given the slack in the economy, and that recent quarterly growth rate movements of the data suggest considerably more economic weakness than do year-over-year observations. However, history teaches us that central banks, particularly the Federal Reserve, are notoriously poor judges of potential output gaps, and that serious policy errors have occurred precisely because they widely misperceived supply conditions. Furthermore, while recent quarterly movements in the data may point to more economic concern for the FOMC, it is not clear that a radical new set of policies should be brought forth on the basis of single quarter's worth of data.

A second powerful reason why additional quantitative easing is risky and unwarranted is that the more a central bank grows its balance sheet, the more it will ultimately have to reduce the size of its balance sheet. In other words, the deeper you dig a hole, the harder it is to climb out of it. Critically, many of the new policies that the Federal Reserve is considering for unwinding the current level of its current balance sheet, while thoughtfully considered, largely involve using unproven and experimental policies. Indeed, paying interest on excess reserves, term deposits for excess reserves, and reverse repurchase agreements are untested and untried methods for draining the enormous amount of liquidity from the U.S. banking system. Likely, these policies can be used in tandem to reduce the size of the Federal Reserve's balance sheet. However, the precise operational quantity of asset sales needed to reach specific macroeconomic objectives for growth and inflation are not currently known, and will require

[1] http://blogs.wsj.com/economics/2010/10/04/bernanke-additional-asset-purchases-could-ease-financial-conditions/?KEYWORDS=bernanke.

[2] http://blogs.wsj.com/economics/2010/10/01/feds-dudley-further-action-is-likely/?KEYWORDS=dudley and http://online.wsj.com/article/SB10001424052748703843804575534043689519572.html?mod=WSJ_hps_LEFTWhatsNews.

[3] See Table 8 of http://www.bea.gov/newsreleases/national/gdp/2010/pdf/gdp2q10_3rd.pdf.

great experimentation. With experimentation will come successes and failures. Correspondingly, the larger the experiment, the larger will be the successes and failures. Be prepared for ups and downs in our brave new monetary world, along with the associated amplified levels of uncertainty and volatility.

So what is pressing many central banks, and in particular the FOMC, to take on their newly aggressive stance? The answer is that central banks are doing so because of high unemployment rates. Indeed, the Fed's dual mandate of price stability and maximum employment is a primary factor in its increasingly dovish position. Clearly, the political headwinds are blowing in favor of using monetary policy to stimulate aggregate demand in order to raise the demand for workers and ultimately chip away at the unemployment problem.

However, a major issue in the unwillingness by firms to expand employment is the heightened perceived level of the cost of doing business, not necessarily their ability to get access to loans. In other words, the high unemployment rate is in large part now a supply issue, not a demand one. Tax rates and the reduction in tax policy uncertainty are likely to be more important than monetary stimulus in solving our unemployment crisis. Instituting a lower tax schedule for households and firms will do more to lower unemployment than additional monetary or government spending stimulus, as the latter do not address the fundamental supply issues at hand.

More broadly, just as monetary policy needs to be put on solid long term footing, so does fiscal policy. Policymakers need to begin establishing a credible and sustainable long run fiscal policy for their countries, even as they run large current cyclical deficits. To accomplish this, they will need to keep in mind at least fourth things. First, adopt a set of fiscal rules and institutions that credibly commit to lowering future deficits and reducing the future level of government debt. Second, adopt a clear set of guidelines for a more transparent government accounting system that provides both a unified budget and that incorporates unfunded future commitments to benefits. Third, politicians need to right-size the size the government by taking into consideration not just the level of government services that a nation needs to provide its citizens, but also how the size of government influences the level of taxation that is ultimately borne by households and firms. Finally, governments need to put in place a tax system that creates the fewest inefficiencies and impediments to economic growth, investment and employment, in order not to jeopardize our prosperity and economic well being.

Just as I began, I close by noting once again that economic policy is at a crossroads. Long run sustainable policies beget long run sustainable economic prosperity. That's how to win the peace. Until we address the former, the latter will continue to elude us.