Monetary Policy and Economic Performance

Mickey Levy
Bank of America

Shadow Open Market Committee
October 21, 2011

The economy is underperforming. The recovery from deep recession has been slow, and the unemployment rate remains above 9 percent. Europe is in financial crisis that could spill over into the US. Public frustration stems from the weak economic conditions, high unemployment and the lack of confidence in US policymakers and their policies.

The Federal Reserve is in an uncomfortable predicament. It has reduced interest rates to zero, pumped trillions of dollars into the financial system, and is now engaging in “operation twist”. Bond yields are low, yet the economy is not responding. Congress, financial markets and the media always turn to the central bank in times of trouble, and the Fed feels pressure to comply and ease monetary policy further. The Fed has not come to grips with the limitations of monetary policy. Complying with the pressure to ease further—to do something—may involve high risks, even if inflation remains low in the near term.

Presently, with negative real interest rates and monetary stimulus at full tilt, the key factors inhibiting economic growth and job creation are nonmonetary in nature and many are beyond the scope of the Fed. The Fed must acknowledge these limitations and suggest the appropriate policy tools that would boost economic performance. Traditionally, the Fed has shied away from offering policy prescriptions outside of monetary policy. However, in light of the Fed’s heavily involvement in fiscal policy and credit allocation, and the disturbing lack of economic leadership in Washington, its constructive suggestions about broader economic policies are now appropriate.

The present situation is tricky for the Fed. Its dual mandate established by the Full Employment Act of 1978 requires monetary policy be geared toward low inflation and low unemployment. Yet core inflation has risen to the Fed’s 2 percent long-run objective, despite measures indicating significant slack in the economy, while the unemployment rate has remained disturbingly high. Aggregate demand is weak, with nominal GDP growing just below 4 percent year-over-year, while headline consumer inflation is over 3 percent. The Fed expresses little concern about inflation, and a lot of concern about high unemployment and insufficient aggregate demand. But current circumstances do not fit into the Fed’s standard models of the economy.

The key factors that are now inhibiting economic growth and job creation do not stem from insufficient monetary stimulus, and cannot be overcome within a reasonable period of time by more monetary easing. Nonmonetary factors are impeding demand as well as production. These include household deleveraging following the unsustainable debt bubble; adjustments to the large decline in household net worth; the large pool of distressed and negative equity mortgages and legal entanglements that are inhibiting necessary foreclosures and are a drag on the housing and mortgage sectors; and the several million unemployed construction workers and the many semi-skilled in the labor force with poor job prospects. Some of these issues are within the scope of the Fed’s monetary policy while others clearly are not. The Fed must consider these factors as it weighs the potential benefits and risks of any policy interventions.

Deleveraging and Housing

The deleveraging process is well underway, but it has further to go. The run up in household debt was massive—from 1998Q3 to 2006Q3, household debt rose at a 10.4 percent annualized pace, surging from 88.3 percent of disposable personal income (DPI) to a peak over 130 percent. Most of the debt run up occurred in mortgages (including home equity loans) while the increases in credit card debt relative to income were relatively modest. Since its peak, the ratio of household debt to DPI has retreated below 115 percent.

Higher household saving and slower spending growth has led to less production and employment and trimmed business expansion plans, a pattern that seems likely to continue. Households are paying down debt, and banks are writing off seriously delinquent loans, restructuring others and tightening credit standards on new loans. On a favorable note, the Fed's lower interest rates have helped reduce the ratio of debt service-to-disposable income (including credit card, mortgage and home equity loan payments) to a manageable level. However, the persistently high unemployment (and high levels of long duration unemployment) and decelerating real disposable income growth, attributable in part to higher inflation, has hindered necessary balance sheet adjustments.

Reducing mortgage debt has posed the largest and thorniest problem. As home values have fallen sharply and the unemployment rate has soared, high mortgage delinquency rates have persisted. Lower home values have constrained the ability of homeowners to refinance their mortgages at favorable rates. CoreLogic reports that 10.9 million residential properties with mortgages, or 22.5 percent, have negative equity, with loan balances exceeding corresponding home values.

Mortgage lending standards have tightened significantly. This has resulted from high rates of delinquency and uncertainty about home prices, as well as tighter government regulations, the tangle of lawsuits surrounding distressed mortgages and the foreclosure process and the associated weakness in the loan syndication market. Mortgage rate spreads over US Treasury yields have widened, thwarting the Fed's efforts to lower bond yields. Down payment requirements have risen, paperwork has become more burdensome and the time-to-close mortgage applications has lengthened. The volume of mortgage refinancing in response to the dramatic declines in bond yields has been disappointing, and new home equity loans have dried up. Government actions have exacerbated the situation.

Not surprisingly, unprecedented monetary easing has not cleared up the problems facing the mortgage and housing markets. Unclogging the dysfunctional mortgage markets, resolving the huge problem of distressed mortgages and the myriad related lawsuits require changes in regulatory policy and other government actions. Leaning too heavily on monetary policy is unproductive and may involve high risks.

The problems in the mortgage market hinder necessary adjustments in housing. Home sales remain weak despite sharply lower home prices and mortgage rates. The inventory of unsold homes on the market is high – above 8 months of current sales volume – and approximately 1.5 million of pending foreclosures add to so-called "shadow inventories". This adds to uncertainty about future home prices, and constrains demand.

Labor Markets

High unemployment poses a major dilemma for the Fed. What if the Fed is unable to achieve its dual mandate, at least within a reasonable period of time? According to standard analyses, only a small portion of the rise in the unemployment rate is structural. However, that does not necessarily mean that the remainder can be readily corrected by traditional countercyclical monetary stimulus. The Fed's successive monetary easing efforts and its seeming willingness to ease more assumes that it is (the Fed considered QEIII at its September FOMC meeting). But the persistent labor market weakness despite unprecedented monetary stimulus suggests other factors are at work.

Consider recent labor market trends: during recession, 8.7 million nonfarm jobs were lost, almost 3.5 million more than would have been anticipated (based on past historical relationships) even with the 5.1 percent decline in real GDP. Real GDP has recovered very gradually—growing a tepid 5 percent in the first 8 quarters—to get within 0.5 percent of its prior expansion peak. Nonfarm jobs have risen 2.1 million from their trough, but remain 6.6 million, or 4.8 percent, below their prior peak, and the unemployment rate has stayed dramatically higher.

The prospects in select sectors suggest very slow improvement, even if aggregate demand picks up. Two sectors of the labor market—construction and government jobs, traditionally key sources of job gains during prior recoveries—are contracting. Construction jobs have typically comprised 4 to 5 percent of the total US labor market. Yet they have declined over 1.9 million since the prior expansion peak, representing almost 29 percent of net jobs lost. With the peak of construction employment associated with residential overinvestment, a sizeable portion of the lost construction jobs will not return, and those that do return may do so over a lengthy period. Some unemployed construction workers face obstacles—skills, geographic immobility, etc—that are slowing the transition to renewed employment.

State and local government employment, which has been declining at a steady rate in 2010-2011, seems destined to contract further. Over several decades, those jobs increased dramatically faster than either population (or, for educators, education enrollment), and with the financial pressures currently facing state and local governments, further reductions in public sector jobs are likely.

The Fed Begins to Acknowledge its Limitations

When QEII was announced, Chairman Bernanke argued that the vast majority of the increase in the unemployment rate was cyclical. This implied insufficient demand that could be boosted by more monetary stimulus. The slow recovery and weak employment gains have forced Bernanke and other Fed members to temper their expectations. Fed statements about a "4 or 5 year" adjustment period to reduce the unemployment rate to its natural rate suggest that nontraditional cyclical factors are at play, even if they do not fit neatly into the "structural" category. Recently, in testimony before the Joint Economic Committee (October 4, 2011), Bernanke acknowledged the important role of nonmonetary policies and alluded to the limitations of monetary policy:

> Monetary policy can be a powerful tool, but it is not a panacea for the problems currently faced by the U.S. economy. Fostering healthy growth and job creation is a shared responsibility of all economic policymakers, in close cooperation with the private sector. Fiscal policy is of critical importance…but a wide range of other policies—pertaining to labor markets, housing, trade, taxation and regulation, for example—also have important roles to play.

The Fed should take to heart what it is saying. The Fed needs to reconsider the limitations of monetary policy and the proper course to take when it faces pressures to try to achieve economic objectives beyond its capabilities. Presently, the Fed justifies its easing stance by saying "as long as inflationary expectations remain well anchored, more monetary easing helps on the margin." But such statements assume that the costs of such policies are negligible, which may not be the case. The Fed's quantitative easing and operation twist distort financial and credit markets, and reduce the value of the US dollar, which lowers US household purchasing power and living standards. Does the combination of QE and operation twist push the Fed's balance sheet into a vulnerable predicament that would be costly to exit if inflation or inflationary expectations rise? The Fed ignores the possibility of a shift in market expectations. Why pursue more monetary easing if other policy tools are much more suitable for addressing current economic problems at a much lower cost? The risks of current monetary policy seem to far outweigh the benefits.

The current high unemployment rate conditions are more nuanced, marked by growth-inhibiting factors that fall in between "cyclical" and "structural". More than just countercyclical monetary stimulus is required; applying countercyclical policies will disappoint and may lengthen necessary adjustments. Specific sources of economic weakness must be identified and addressed with the proper policy tools.

The Fed Should Make Nonmonetary Policy Recommendations

To his credit, Bernanke has been increasingly outspoken in urging fiscal policymakers to address the long-run structural budget imbalance (while noting that quick implementation would pose a fiscal drag), but the Fed needs to go further. It should clarify which fiscal actions aimed at closing the long-run budget imbalance would enhance economic growth and which ones would not. It also needs to weigh in on the potential benefits and shortfalls of short-term fiscal stimulus measures, as well as tax policy. After all, in the long run, sound monetary policy requires sound fiscal policy.

Historically the Fed has not opined on fiscal policy in such detail, but if fostering healthy economic growth and job creation is truly a shared responsibility, as Bernanke states, then part of the Fed's responsibility is to support sensible policies—and oppose ones that are heading in the wrong direction. Monetary policy is already closely intertwined with fiscal and regulatory policies and credit allocation, and the Fed should be weighing in on these issues.

It is well known that entitlement reform—of Social Security, Medicare and Medicaid—is an absolute necessity. The Fed should point out that cutting discretionary programs, as mandated under the Budget Control Act of 2011, not only sidesteps required entitlement reform and raises its long-run cost, but also may harm economic performance by forcing cuts in discretionary programs which should be expanded (including education, research and development and infrastructure).

The Fed should emphasize that tax reform—corporate and individual—is a high priority. Reform efforts should be guided by standard objectives of efficiency, fairness and simplicity. Raising taxes is not a substitute for entitlement reform. However, raising taxes as part of a far-reaching compromise to close the long-run budget imbalance should be considered; the focus should be base-broadening that improves economic efficiency and reduces distortions—through reductions in deductions, exclusions, exemptions, credits and deferrals—rather than tax rate hikes that dull incentives.

The Fed's stance on short-term countercyclical fiscal stimulus should rely on its research findings: temporary programs aimed at temporarily boosting demand and jobs tend to have a relatively poor track record, while permanent changes that incent workers to work and businesses to hire have significantly stronger and longer lasting impact. The government's credibility has been diminished by its focus on short-term temporary programs that have been rolled out with great fanfare only to subsequently disappoint in their effectiveness. The Fed should emphasize the importance of rebuilding credibility.

The Fed should also urge reform of housing finance and GSE reform. It should emphasize the macroeconomic benefits of the government facilitating rather than inhibiting resolution of distressed mortgages. It should also urge the government to address the inefficiencies in the mortgage market, including all of the government lawsuits filed against banks, mortgage originators and servicers, which are adding uncertainty and contributing to tighter mortgage lending standards, higher risk premia and inefficiencies in the MBS market. The Fed should also readdress the regulatory burdens that are clogging up finance, lending and the intermediation process.