SORTING OUT MONETARY AND FISCAL POLICIES

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Monetary and fiscal policies have both gone off track. 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 growths but has distorted financial behavior and involves sizable risks. Fiscal policies have resulted in an unhealthy rise in government debt, and projections of dramatic further increases heap burdens on future generations and 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 unwind its balance sheet but be more aggressive than indicated in its current strategy. The Fed should aim to reduce its balance sheet to the point in which excess reserves are kept relatively low, and it should

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fully unwind 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 overreach, including removing itself from credit allocation policies and toning down its excessive focus on short-term fine-tuning.

The longer-run projections of government debt are alarming and must be taken seriously. General government debt has risen to 100 percent of GDP, up from 61 percent before the 2008–09 financial crisis, while publicly held debt, which excludes debt held for accounting purposes by the Social Security Trust Fund and other trust funds, has risen to 78 percent from 40 percent. The Congressional Budget Office (CBO) estimates that under current law, the publicly held debt-to-GDP ratio is projected to rise to nearly 150 percent by 2047. Congress must develop and implement a strategy that guarantees sound longer-run finances. This requires tough choices, particularly as it addresses the ever-growing entitlement programs, 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 current spending on infrastructure, research and development, and other activities that would enhance economic performance. Under current laws, these budget constraints—those at the federal level as well as those facing state and municipal governments—will only increase in severity.

Congress’s fiscal agenda must be two-pronged. First, Congress 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. This requires transforming the government’s annual procedure of budgeting of appropriations for the array of the so-called discretionary programs and dealing with the entitlement programs from a “deficit bean-counting” exercise into a strategic process that carefully assesses the structure of key programs and their objectives—whether they are meeting their policy and social objectives; whether they are doing so effectively; their
unintended side effects; and how they may be enhanced, modified, and cut.

Second, Congress must enact laws that gradually phase in reforms of the entitlement programs that constrain the projected growth of future spending in a fair and honest way, improving the benefit structures of the programs with the objectives of protecting lower income retirees and providing sufficient time for older workers to plan for retirement.

The Proper Roles of Monetary and Fiscal Policies

I fully understand the frustrations stemming from the underperformance 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 addresses 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 4.3 percent, below standard estimates of its “natural rate” (so-called 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 and real wages. Rather, monetary policy is an aggregate demand tool. The major sources of underperformance involve structural challenges that are beyond the scope of monetary policy 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 involves the Fed’s control of 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 past and current 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 federal government’s budget is the rapid expansions of Social Security, Medicare, and Medicaid. According to the CBO (2017), outlays for Social Security, Medicare, and Medicaid, and health-care related entitlements have risen from 47 percent of total federal outlays (10.1 percent of GDP) in 1992 to 62.9 percent of federal outlays (13.2 percent of GDP) in 2017. These programs are projected to rise dramatically further to 65.3 percent of federal outlays (15.4 percent of GDP) by 2027.

The objectives of these entitlements are laudable, and they are critical for government and society. However, the growth in these programs has been the primary source of the rising government debt (and projections of further increases), and has significantly increased the share of government spending allocated to income support and health. Consequently, spending on other programs has been squeezed, including those that would enhance longer-run productive capacity. For virtually every state, Medicaid spending is one of the largest and fastest growing spending programs. Faced with rigid balanced-budget constraints on their operating budgets, states have cut back on the provision of some basic government goods and services.

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 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 “noncompete” 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.

Regulatory policies deserve attention, in the discussion about the efficacy of monetary and fiscal policies, because they have unique economic effects that may work at cross-purposes to monetary and fiscal policies. In order to establish public policies that improve standards of living, we need to address the sources of economic and labor underperformance with the proper policy tools, rather than rely on standard monetary and fiscal stimulus that are unlikely to have desired outcomes but are costly and generate unintended side effects.

The Fed’s Expanded Scope

The Fed deserves credit for its quantitative easing (QE) in 2008–09 that helped to 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 its large-scale purchases of MBS and its “bailout” of AIG, directly involved the Fed in credit allocation and fiscal policy. At the time, Fed Chairman Ben Bernanke (2008) explicitly identified these Fed interventions as temporary emergency measures, and stated that the Fed would exit them on a timely basis.

But the efficacy of the Fed’s unprecedented monetary ease well after the economy had achieved sustainable growth and financial markets had stabilized—the dramatic expansion of its large-scale asset purchase programs (LSAPs) and targeting the Fed funds rate below inflation—is questionable, and the expanded scope of monetary policy involves substantial risks. These policies and the Fed’s forward guidance have stimulated financial markets and asset prices, but the economy has been largely unresponsive. Nominal GDP has not accelerated—it has averaged 3.6 percent annualized growth since the Fed implemented QE3 in Fall 2012—and real growth has been subnormal. 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 underemployment persist.
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Nonmonetary factors including government tax and regulatory policies have hampered credit growth and economic performance (Levy 2017). In banking, the burdensome regulations imposed by Dodd-Frank and the Fed’s stress tests have deterred bank lending (Calomiris 2017). The Fed’s low rates and forward guidance aimed at keeping bond yields low have dampened expectations. Meanwhile, the Fed’s policy of paying interest on excess reserves (IOER), which began in October 2008, at a rate above the effective fed funds rate, has increased the demand to park reserves at the Fed rather than lend them out (Selgin 2016). Despite the dramatic surge in the Fed’s monetary base, M2 has grown at a modest 6 percent rate in recent years. The response of aggregate demand has been tepid, and velocity has declined. This reflects several factors. Lower interest rates have increased the demand for money. The Fed’s forward guidance has reinforced a sense of caution in the economy. In addition, burdensome regulations have inhibited the supply of bank credit and the monetary policy channels have been clogged. As a result, the high-powered money created by the Fed’s LSAPs remain as excess reserves on big bank balance sheets and have not been put to work in the economy (Ireland and Levy 2017).

In the nonfinancial sector, the array of taxes and regulatory burdens and mandated expenses imposed by federal, state, and local governments have constrained business and household spending. Of note, these government-imposed burdens have led businesses to raise their required hurdle rates for investment projects and many job-creating expansion plans have been scuttled. Capital spending has been disappointing in light of the low real costs of capital and strong corporate profits and cash flows.

The Fed takes far too much credit for the sustained economic expansion and labor market improvement of recent years. 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.

Through most of the expansion, the Fed viewed the low wage gains and inflation as a rationale to enhance and maintain its efforts to use monetary policy to stimulate economic growth. Effectively, the Fed’s mindset has evolved into the belief that its role is to manage the
The Fed has rejected the notion that its persistently easy policies have been ineffective—much less the possibility that its policies may have had negative effects. Recently, the Fed has changed its tune. In a speech in March 2017, entitled “From Adding Accommodation to Scaling it Back,” Fed Chair Janet Yellen identified “unwelcome developments” affecting economic performance that “reflect structural challenges that lie substantially beyond the reach of monetary policy.” She continued to state that “Fiscal and regulatory policies—which are of course the responsibility of the Administration and Congress—are best suited to address such adverse structural trends” (Yellen 2017).

Along with weak productivity gains, the failure of nominal GDP to accelerate in response to the Fed’s unprecedented monetary ease has been a key reason why wage increases have remained modest and inflation has remained below the Fed’s 2 percent target. The slow (and nonaccelerating) growth of aggregate product demand has influenced wage and price setting behavior, reducing the flexibility of businesses to raise product prices and reducing their willingness to grant higher wages. Slow growth in nominal GDP—it has averaged 3.4 percent so far this expansion compared to 5.3 percent in the 2001–07 expansion and 5.6 percent during the 1990s—is statistically significant in explaining the slow wage gains despite the low unemployment rate (Levy and Reid 2016). Additionally, inflation has been constrained by declining quality-adjusted prices of select goods and services stemming from technological innovations and product improvements. Most notably, the PCE deflator for durable goods has fallen persistently since the mid-1990s. These innovations have increased consumer purchasing power and benefitted the economy.

The Fed’s historic tendency to fine-tune the economy and financial markets has been accentuated during this expansion. This was apparent when the Fed implemented QE2, Operation Twist, and QE3 in an explicit effort to lower unemployment, and since 2014 when the Fed delayed tapering its asset purchases and then stuck to its reinvestment program to maintain its oversized portfolio. The Fed has been heavily influenced by short-term fluctuations in the economy, and by global and domestic asset markets. It has modified its employment mandate to include focus on 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 and expanded role historically have led to policy mistakes.
The Fed’s Balance Sheet

As a result of these short-run concerns, the Fed maintains a balance sheet of $4.5 trillion, including $2.5 trillion of U.S. Treasury securities of various maturities and $1.8 trillion of MBS, primarily with long maturities. The Fed is now the largest holder of each, with 17 percent of outstanding federal publicly held debt and 12 percent of MBS outstanding. (The Fed’s holdings of Treasuries are counted as publicly held debt because the Federal Reserve Banks are legally capitalized by the private sector banks in their districts). Prior to the financial crisis, the Fed’s balance sheet was roughly $850 billion, composed nearly entirely of short-term Treasuries and other liquid securities.

The Fed has begun a strategy of gradually and passively unwinding a fairly even portion of its Treasury and MBS holdings by reinvesting all but a small portion of principle of maturing assets. Although the Fed has not been clear about the ultimate size of balance sheet it wishes to maintain, several Fed members have indicated that its ultimate aim is to maintain a large buffer of excess reserves. This strategy should be modified. 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—to stabilize a completely dysfunctional and illiquid market that posed a threat to global markets—continuing to hold MBS makes little sense. Mortgage markets are functioning normally with sufficient liquidity. The Fed’s ongoing explicit subsidies of the housing sector are irrational, and the Fed should go back to an all-Treasuries portfolio.

The Fed’s intention to maintain a large buffer of excess reserves implies a shift from pre-financial crisis operating procedures, in which the Fed’s much smaller asset portfolio resulted in a minimal amount of excess reserves. The Fed has built an argument that maintaining a large amount of excess reserves going forward would benefit the Fed’s conduct of monetary policy and enhance its ability to stabilize financial markets. The maintenance of 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
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involve less excess reserves in the banking system, like the Fed used through most of its history prior to the financial crisis in 2008–09. With minimal excess reserves, the Fed used a market-based “corridor system” in which it managed the effective funds rate close to its target rate through open-market purchases and sales of assets. Going back to its traditional operating procedure would allow the Fed to lessen its exposure in the overnight reverse repo market and in general constrain its overall footprint in financial markets. 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 have combined to 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 U.S. Treasury reached a peak of $117 billion in Fiscal Year 2015. They have receded in 2016 and 2017 as the average yield on the Fed’s portfolio has receded and the Fed’s rate hikes have increased the interest it pays to commercial banks under IOER. These large remittances to the Treasury have materially reduced recent budget deficits.

While this deficit reduction 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. Congress seems to perceive that the Fed’s outsized profits remitted to the Treasury are risk-free and permanent, when in fact they involve sizeable interest rate risks. Moreover, the Fed’s balance sheet exposes monetary policy to undesirable budget practices and may undercut the Fed’s independence and credibility.

At a recent congressional hearing held by the House Financial Services Committee on the interaction between monetary and fiscal policies, Congressman Brad Sherman (D–CA) heaped praise on the outsized net profits the Fed remits to the Treasury and asked, “What would the Fed need to do to double (to $200 billion)
the amount of profits it remits to the Treasury?” This question may seem amusing to monetary economists, but it illustrates a lack of understanding about the proper role of monetary policy and highlights the Fed’s potential vulnerabilities. The Fed should not understate the political-economic risks of maintaining such a large balance sheet. By suppressing deficits and debt service costs, the Fed’s outsized remittances have eased pressure on Congress to address the growing budget imbalance. Also, as illustration of how Congress may misuse the Fed’s large remittances, in December 2015, Congress’s enactment of the FAST Act to provide financing for transportation infrastructure redirected a small portion of the Fed’s assets and some of its net profit into the Highway Trust Fund. The Fed did not protest the way this budgetary “sleight of hand” procedure inappropriately used monetary policy for fiscal purposes.

In light of the magnitude of federal debt outstanding (currently $15 trillion and estimated by the CBO to rise to $27 trillion in 2027), budget deficits and debt service costs are very sensitive to interest rates. The CBO (2017) estimates that a 1 percentage point increase in interest rates from its baseline assumptions over the 10-year projection period would add $1.6 trillion 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 percent point toward higher bond yields. 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 and honest assessment of the government’s budgetary risks of its sustained outsized balance sheet.

Fiscal Policy Influences on Monetary Policy

To date the basic thrust of the Fed’s monetary policy has not been materially influenced by budget deficit considerations, although the Fed takes into account fiscal policy deliberations and is sensitive to the impact some of its extraordinary actions have had on the federal budget. But these have been relatively low-level concerns. A much larger concern centers on projections of dramatically rising government debt and the lack of impetus of fiscal policymakers to address
the issue, which raise the prospects that the government’s finances may exert burdens on the Fed and impinge on monetary policy.

Sound monetary policy ultimately relies on sound government finances (Leeper 2010). 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 case, 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 (Weidmann 2013).

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 reducing the disincentives to invest, rather than temporary fiscal stimulus that involves more deficit spending. This is particularly true with the economy in its ninth consecutive year of expansion and clearly displaying signs of self-sustaining growth.

Congress faces several alternative fiscal policy paths. It may continue to avoid reforming current spending programs and the tax structure. This would reinforce disappointing economic performance, and downside risks would rise. 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. Alternatively, Congress may reform current spending programs, particularly entitlements, by improving their structures while maintaining their intent. Congress also needs to address the sources of the rising government debt and overhaul the tax system. The latter requires reducing marginal tax rates, particularly corporate taxes; broadening the tax base through eliminating the array of deductions, deferrals, exemptions and credits; and simplifying the tax code. Those efforts would lift sustainable economic growth, improve productivity, increase wages and economic well-being of underperformers in labor markets, ease burdens on income support systems, and improve government finances. Future concerns are quickly becoming current realities.
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Conclusion

Is it appropriate to be critical of macroeconomic policies amid sustainable economic expansion and low inflation? Yes. Debt projections and the current tax code cry out for reform. The current corporate tax reform initiative is promising. But addressing the government’s deficit spending and rising debt is a thorny challenge. How can current fiscal policymakers be expected to make necessary strategic changes to entitlement programs when doing so may involve short-term political fallout? There is no easy answer, but a good starting point would involve members of Congress learning the basic structures and key details of the biggest government spending programs—beneficiary requirements and benefit structures, the magnitude and distribution of benefits, and how they are financed. Such programmatic knowledge could become a healthy basis for a more economically rational policy debate and replace the current tendency of fiscal policymakers to make superficial statements on key programs that only serve to polarize the debate.

Redirecting monetary policy is simpler. The Fed must change its mindset. It should purposely narrow the objective of monetary policy to maintain low inflation and inflationary expectations and be more circumspect about the proper role of monetary policy as an input to sustainable healthy economic performance. This would lead the Fed to redirect itself from its recent thrust of “managing the real economy” and excessive fine-tuning, and acknowledge that some challenges facing the economy are better addressed through other economic, fiscal, and regulatory policy tools. This would steer the Fed away from its harmful roles in fiscal and credit policies.

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