Monetary and fiscal follies

In the United States the approach of the November midterm elections has combined with worries about a double-dip recession to rekindle the hot debate over monetary and fiscal policies. Unfortunately, while both the election and the danger of a second dip are drawing closer, a coherent resolution of the policy debate is not.

What no one seems to have noticed is that while the protagonists in these two debates over Fed policy and the budget deficit are different, their arguments are exactly the same.

On one side of the debate over monetary policy are those like James Bullard, president of the St. Louis Fed who are wary of an economic slowdown. They argue that if this danger deepens, the Federal Open Market Committee may have to follow up on the decision at its August meeting not to let the Fed’s balance sheet shrink as its holdings of mortgage-backed securities mature with another round of quantitative easing. Interest rates may have to remain low for a long time to support an economy at risk of lapsing into deflation. One now hears predictions that the Fed will not begin raising rates until 2011 or even 2012.

On the other side are critics like Raghu Rajan, former IMF chief economist, who argue that the Fed should start raising rates now. Low interest rates simply keep the economy on artificial life support. They have the undesirable side effect of fostering the same imbalances that set the stage for the crisis. They encourage releveraging by the financial services industry and relieve the banks of having to worry about liquidity, just as before 2008. They encourage excessive spending and debt accumulation by U.S. households that should instead be deleveraging.

In particular, they encourage spending on housing and automobiles, two interest-rate-sensitive sectors on which the U.S. economy has become overly dependent. They thus interfere with the process of balancing the U.S. economy on a more sustainable footing. They only set up the country for another painful fall.

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The debate over federal fiscal policy similarly proceeds in parallel. On one side are those, like the business economist Mark Zandi, who are preoccupied by the weakness of the economy and stress the need for continued support for aggregate demand. They observe that the impact of the stimulus peaked in the first quarter and worry about the implications of allowing the Bush tax cuts to expire at the end of 2010.

On the other side are many voices arguing that the United States needs to save more in order to avoid the mess it got into in the last decade. While households are now saving more, the increase in national savings for which they account has been entirely offset by less government savings. As a result, the U.S. is becoming even more heavily indebted to the rest of the world. The trade deficit, having shrunk temporarily during the crisis, is rising again toward pre-crisis levels. If foreigners at some point become unwilling to bankroll that deficit, the consequences could be dire.

Meanwhile, efforts to rebalance the economy toward exports in order to double U.S. exports in five years, the goal set by President Obama, have been frustrated. Only a concerted effort to cut the budget deficit, it is argued, can finally get the U.S. started down this road.

The two sides in the debate over fiscal policy are thus making exactly the same points as their counterparts in the monetary debate. And because both sets of economists are making the same arguments — without realizing it — you can lay them end to end, and they still will never reach a conclusion.

Once one realizes that exactly the same arguments are being made in the monetary and fiscal contexts, some powerful implications follow. First, budgetary policy is better suited than monetary policy to encourage rebalancing the U.S. economy away from housing and toward workforce skill formation. If the U.S. needs more skilled workers in order to export more, then the budget is the appropriate instrument for financing the expansion of vocational training. If the U.S. should be investing less in housing in the medium term, then eliminating the federal tax deduction for mortgage interest — that is, using the revenue side of the budget — is again the most effective way to achieve this.

Interest rates, in contrast, are too blunt an instrument for changing the mix of investment away from housing and toward workforce skill formation. The Fed can contribute modestly to this adjustment by replacing its maturing residential mortgage-backed securities with treasury bills — not more mortgages — as its current holdings mature. But the main thing that monetary policy can and should do, so long as the expansion remains weak, is to support aggregate demand and prevent deflationary expectations from setting in.

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Policy makers may still have reason to worry that near-zero interest rates will encourage excessive leverage by banks and borrowers. This problem should be appropriately addressed by the Fed in its capacity as regulator.

Fiscal policy, on the other hand, can be deployed in dozens of ways to encourage rebalancing. Most obviously, shifting from an income to a consumption tax would encourage saving over spending. Tax incentives for investing in clean energy and high-speed rail would help to limit motor vehicle and energy imports.

On the export side, more investment in roads, ports, and bridges — rather than homes — would help to make the country’s exports more competitive. Federal financing for vocational training to provide more machinists could be extended to college degrees for service-sector workers, analyses by the International Trade Commission having shown that the service sector provides important support for exports. The federal government could also more adequately fund the regulatory agencies that monitor the country’s food supply so that foreign consumers put off by past reports of tainted American meat will overcome their fears. And it can be more generous in providing credit guarantees for exporters.

President Obama and his defense secretary, Robert Gates, foresee the opportunity for far-reaching cuts in the U.S. defense budget. Once a durable recovery is underway, the money saved should be used to reduce the federal deficit. But until that time, it is best used for ramping up public programs that contribute to rebalancing.

Oh, and since Federal Reserve policy will remain loose for the foreseeable future, we will also be able to rely on a weak dollar to boost exports and help to rebalance the economy.