Monetary and Fiscal Follies

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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 danger of a double 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, 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 relapsing into deflation. One now hears predictions that the Fed won't 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 only keep the economy on artificial life support. They have the undesirable side of 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 their liquidity, just as before 2008. They encourage excessive spending and debt accumulation by U.S. households that should be deleveraging instead.

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 rebalancing the U.S. economy toward a more sustainable footing. They only set up the country for another painful fall.

The debate over federal fiscal policy proceeds exactly in parallel. On one side are those, like the business economist Mark Zandi, preoccupied by the weakness of the economy and stressing the need for continued support for aggregate demand. They observe 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 same mess as in the last decade. While households are now saving more, the increase in national savings for which they account has been entirely offset by additional government dissaving. The U.S., as a result, is becoming even more heavily indebted to the rest of the world. The trade deficit, having shrunk temporarily during the crisis, is rising again, back toward pre-crisis levels. If foreigners become unwilling, at some point, to bankroll that deficit, the consequences could be dire.

Meanwhile, efforts to rebalance the economy toward exports, much less 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 for encouraging rebalancing. 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 of achieving this.

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

Policy makers may still have reason to worry that near-zero interest rates will encourage excessive leverage by banks and borrowers. If so, this problem is appropriately addressed by the Fed in its capacity as regulator. The Fed can increase capital and liquidity requirements for the banks. It can require them to adopt more rigorous lending standards. Again, raising interest rates is too blunt an instrument for pursuing these kinds of goals.

Fiscal policy, on the other hand, can be deployed in dozens of ways to encourage rebalancing. Most obviously, shifting from an income tax 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 – as opposed to homes – would help to make the country's exports more competitive. Federal finance 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 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. 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.

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