

Implications of Fiscal Austerity for U.S. Monetary Policy

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Implications of Fiscal Austerity

- Fiscal matters are the subject of intense debate
- Many developed economies have adopted fiscal austerity
- The U.S. reduced real government spending and government employment even before recent payroll tax increase and sequester

Implications of Fiscal Austerity...Continued

- Long-term budget sustainability is critical, but timing is important
- While fiscal policy is only one consideration, more restrictive near-term fiscal policy will delay when we achieve the Fed's dual mandate – currently the unemployment rate is 7.5 percent and PCE inflation is about 1 percent

Implications of Tepid Recovery

- Some call degree of monetary accommodation excessive, but based on outcomes, one could argue we have not been sufficiently accommodative (inflation is below target, unemployment is above the “full-employment” level)
- Part of the “miss” on inflation and unemployment is the emergence of more fiscal restraint than might have been expected (e.g., the sequester became reality)

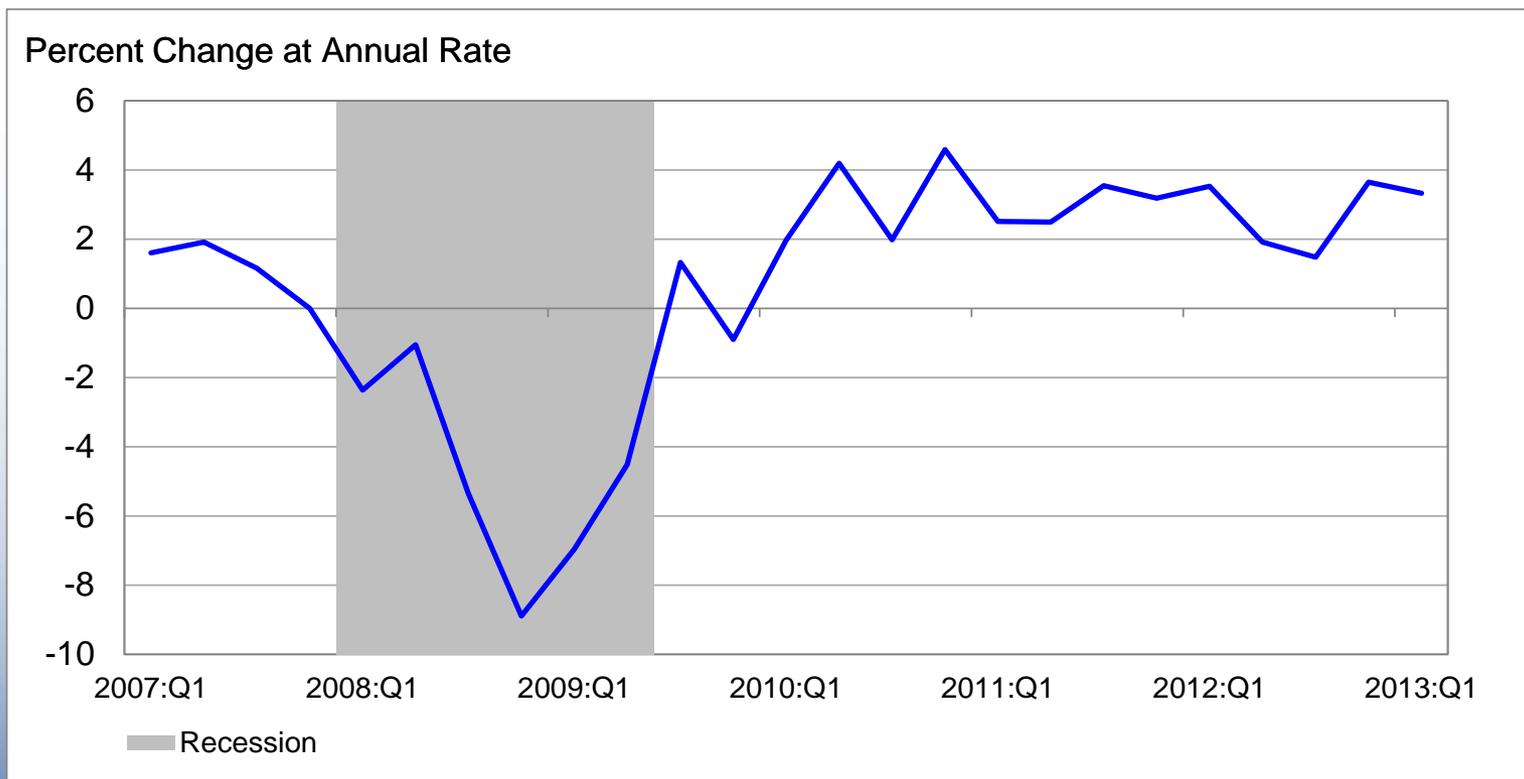
Implications of Tepid Recovery...Continued

- Monetary policy has been effective in generating growth in interest-sensitive sectors and has in part offset the contractionary effects of headwinds – fiscal, financial, and otherwise
- Overall GDP growth during the recovery has been slow. Looking at the *components* of GDP reveals differences and provides perspective

Figure 1

Growth in Real Final Sales to Private Domestic Purchasers

2007:Q1 - 2013:Q1

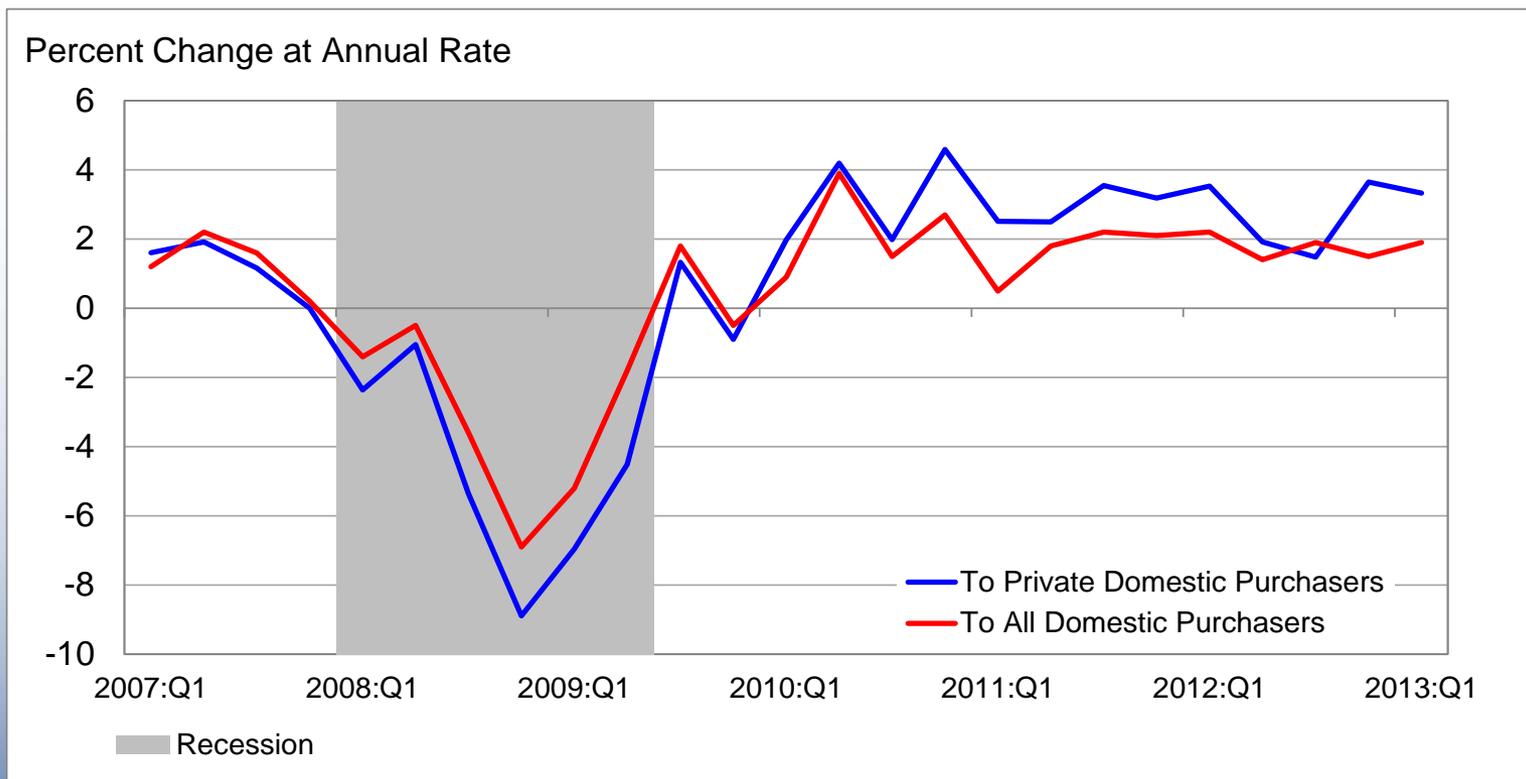


Source: BEA, NBER / Haver Analytics

Figure 2

Growth in Real Final Sales to All Domestic and Private Domestic Purchasers

2007:Q1 - 2013:Q1

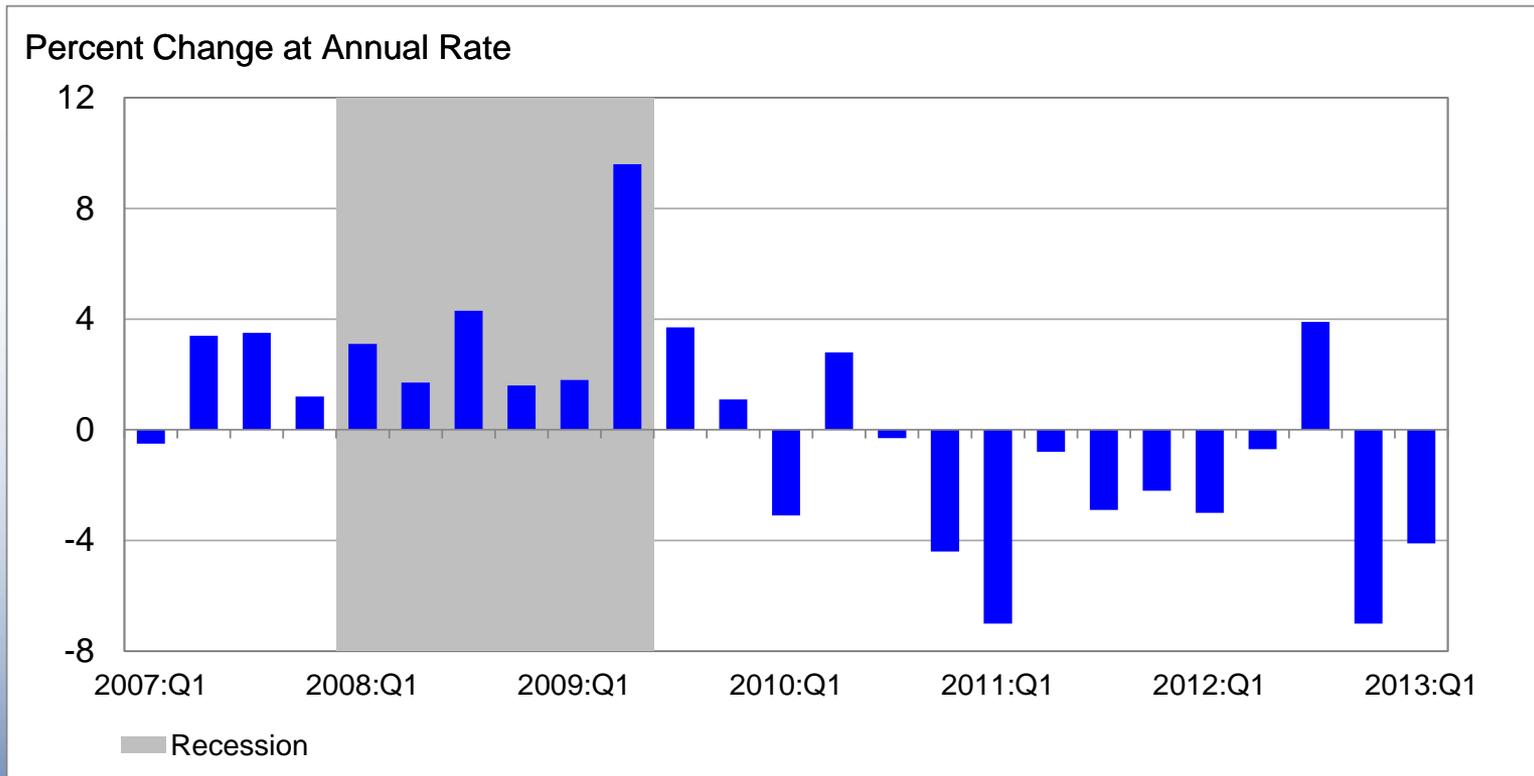


Source: BEA, NBER / Haver Analytics

Figure 3

Growth in Real Government Spending

2007:Q1 - 2013:Q1

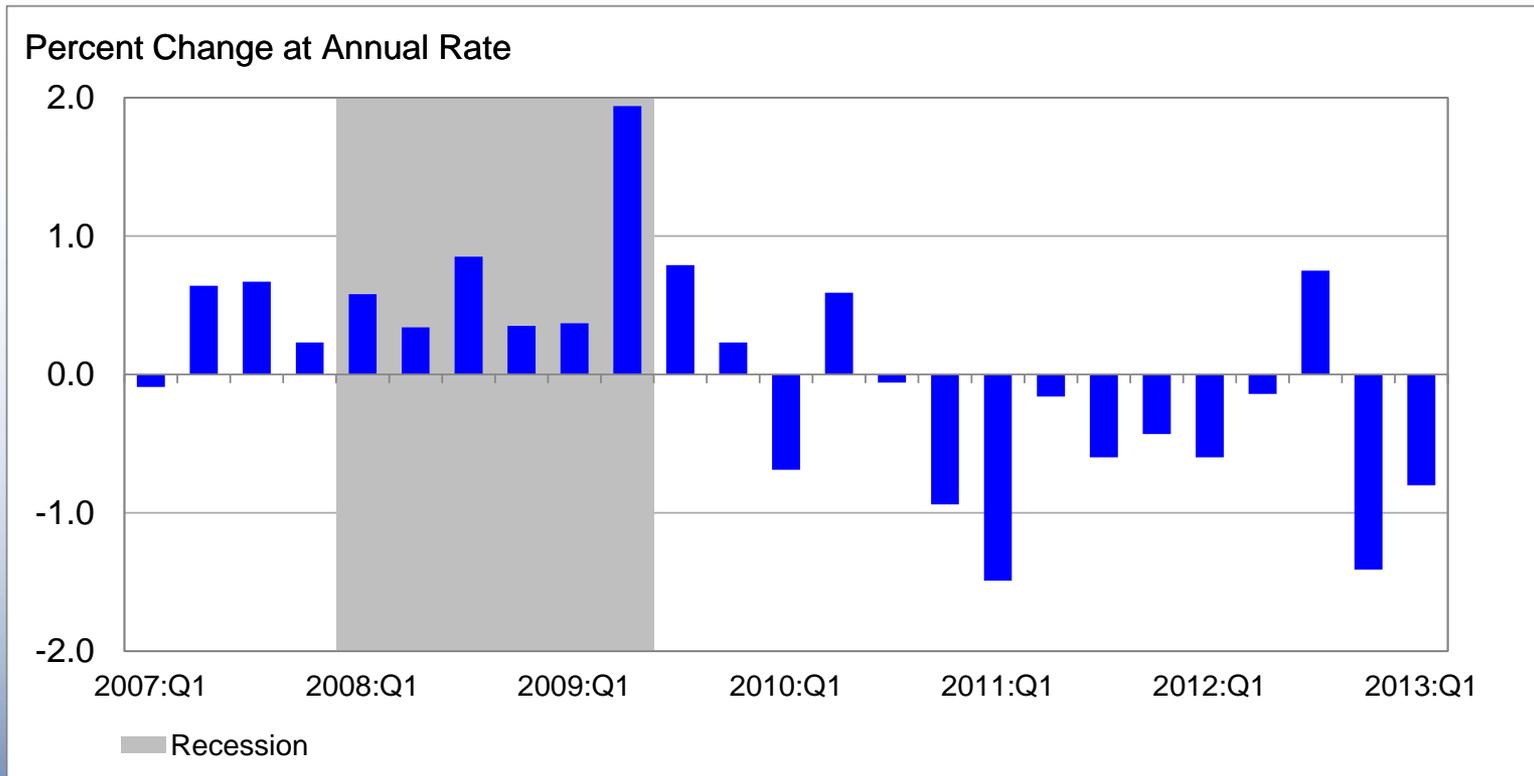


Source: BEA, NBER / Haver Analytics

Figure 4

Contribution of Real Government Spending to Real GDP Growth

2007:Q1 - 2013:Q1

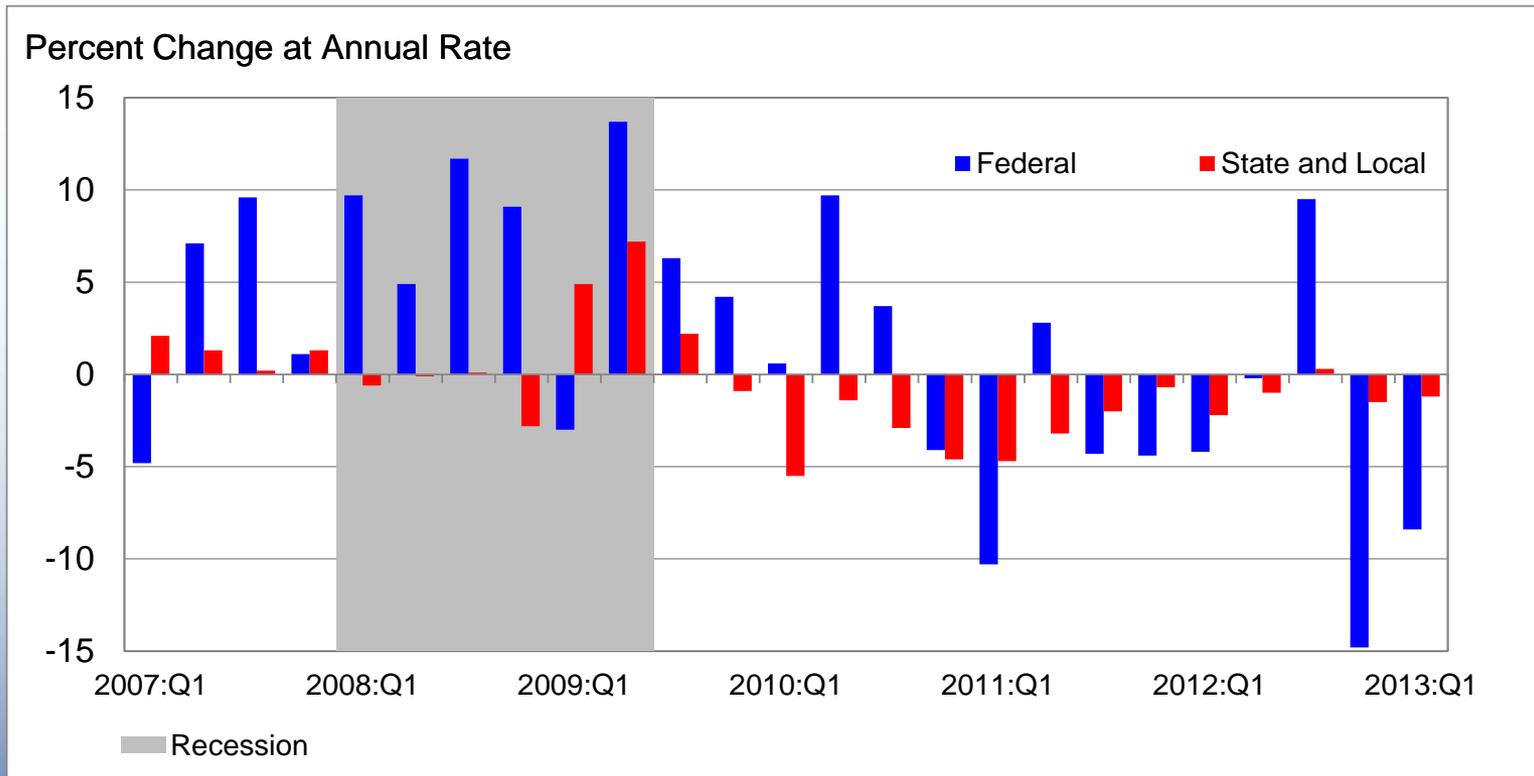


Source: BEA, NBER / Haver Analytics

Figure 5

Growth in Real Government Spending by Federal and State and Local Governments

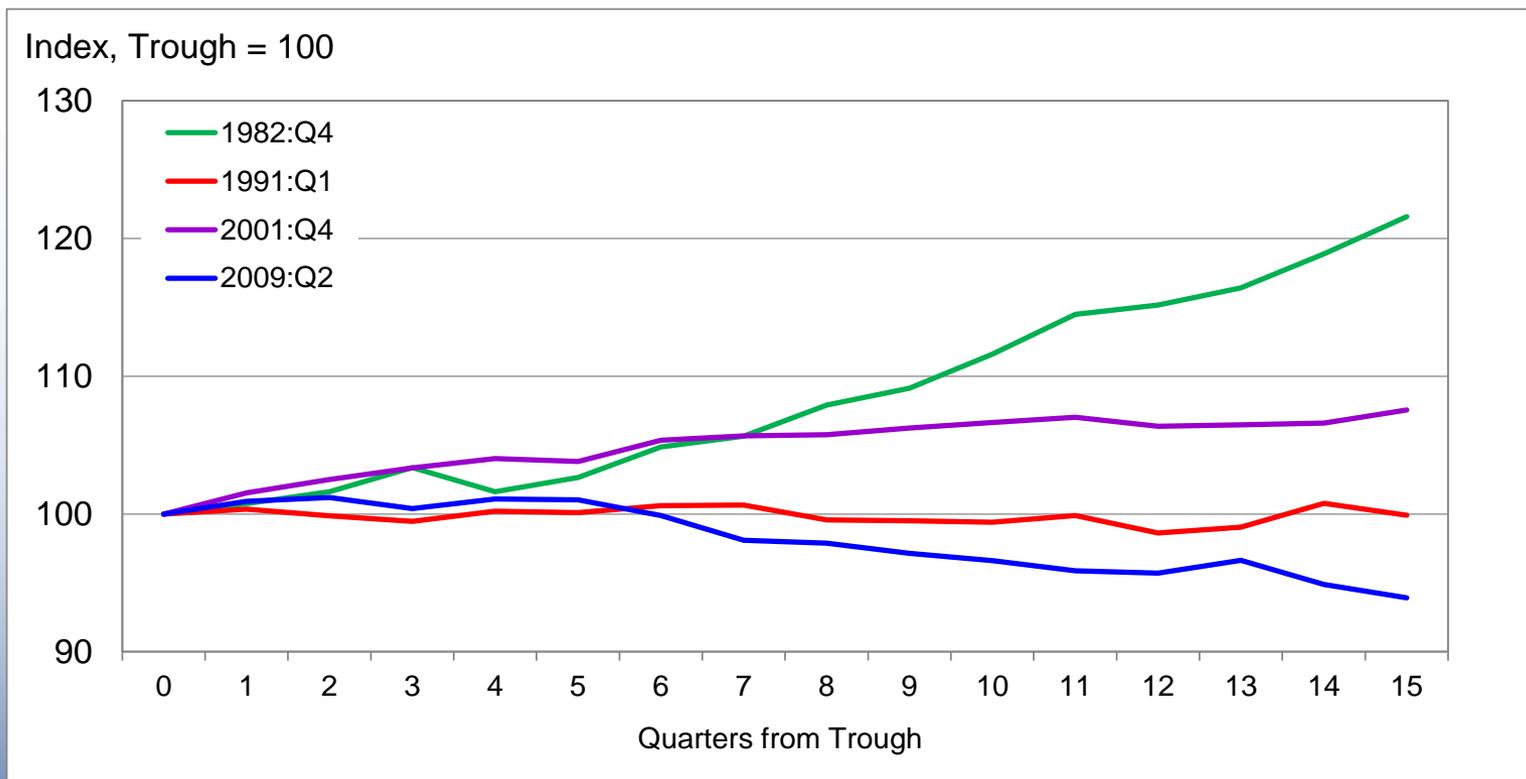
2007:Q1 - 2013:Q1



Source: BEA, NBER / Haver Analytics

Figure 6

Growth in Government Spending During Current and Previous Three Recoveries

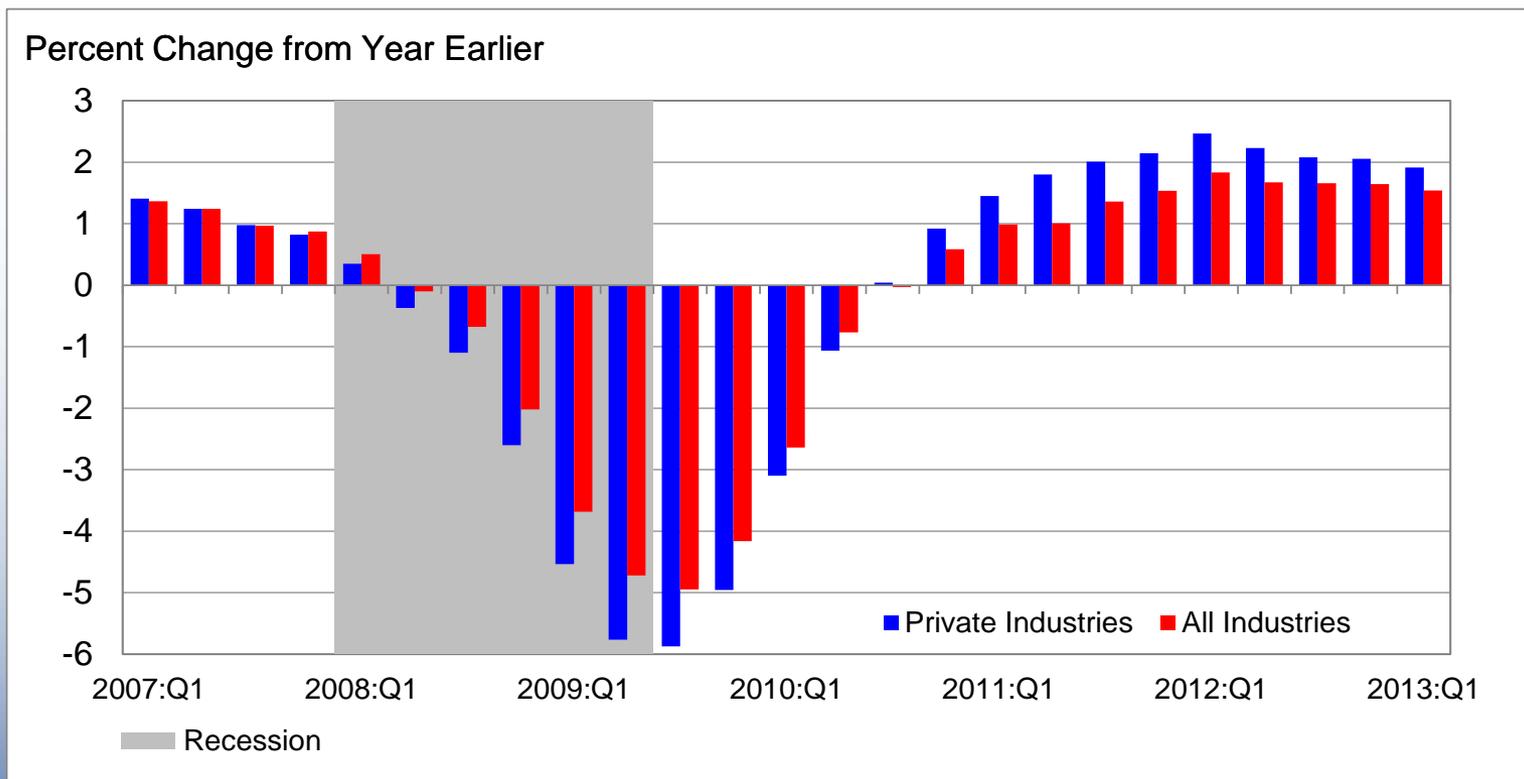


Source: BEA, NBER / Haver Analytics

Figure 7

Nonfarm Payroll Employment Growth: All Industries and Private Industries

2007:Q1 - 2013:Q1



Source: BLS, NBER / Haver Analytics

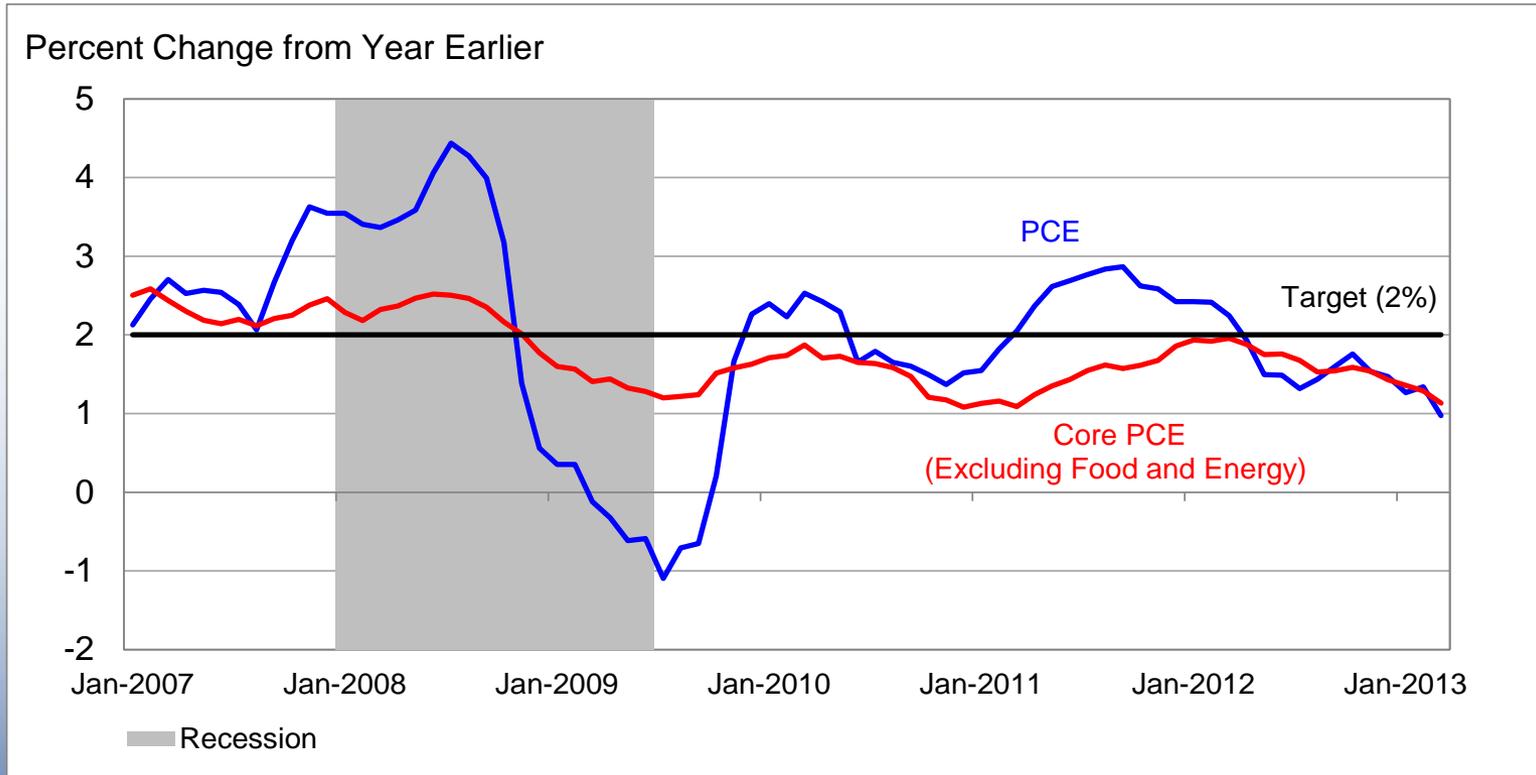
Effects of Fiscal Restraint

- Fiscal restraint has been notable, and has factored into the pace of recovery
- Sectors that are sensitive to accommodative monetary policy have responded
- Monetary policy has ameliorated, but not fully offset, the impact of headwinds (fiscal and otherwise)
 - 2 percent real GDP growth
 - Only gradual improvement in labor markets

Figure 8

Inflation Rate: Change in Total and Core Personal Consumption Expenditure (PCE) Price Indexes

January 2007 - March 2013



Source: BEA, NBER / Haver Analytics

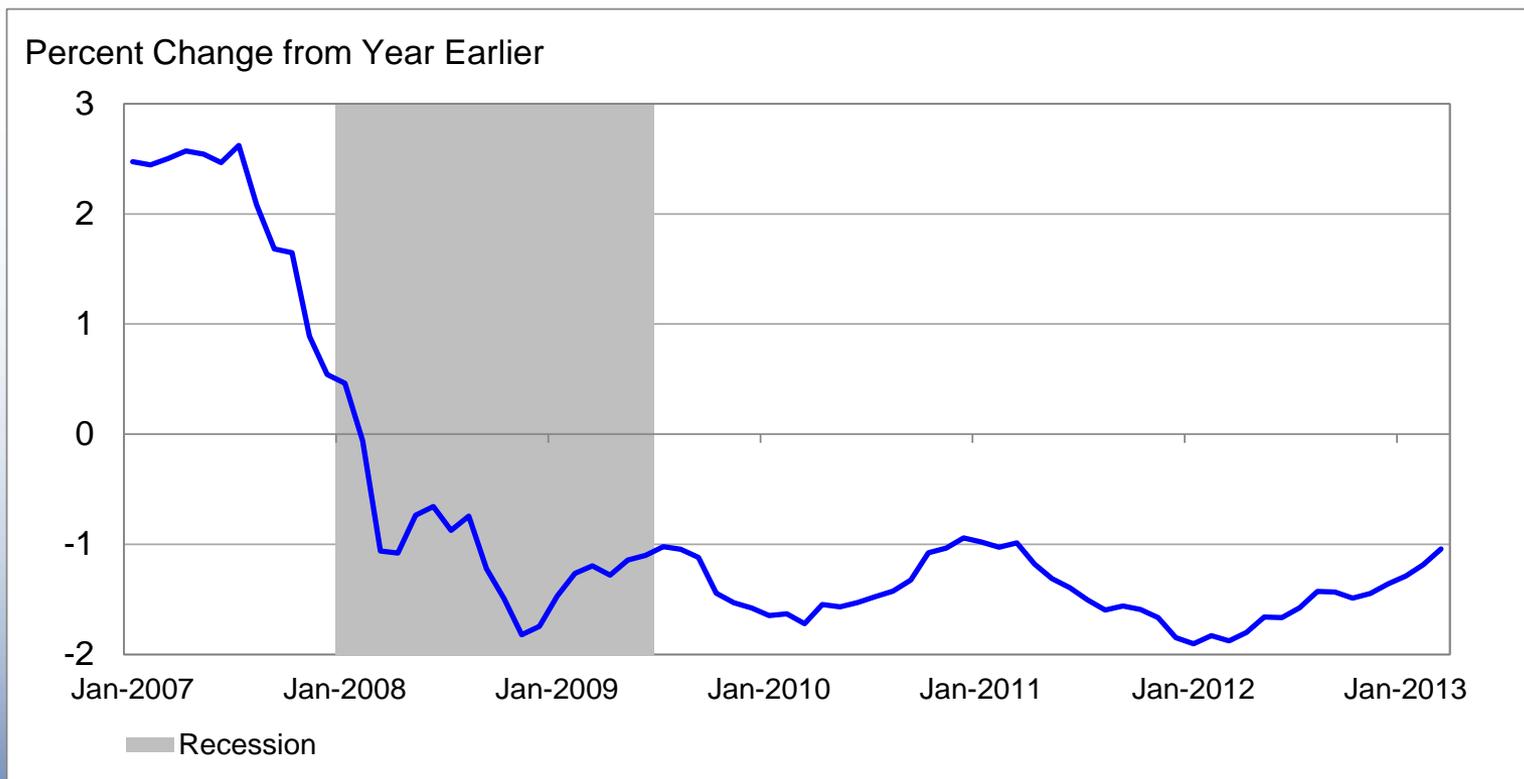
Low Inflation

- The low inflation rate would actually be of concern if the economy suffered a negative shock
- Note the experience of Japan – not addressing persistently low inflation can cause deflation if a negative shock occurs
- Inflation expectations in the United States remain stable – however there are risks to persistently remaining below target

Figure 9

Three-Month Treasury Bill Yield Minus Core PCE Inflation Rate

January 2007 - March 2013



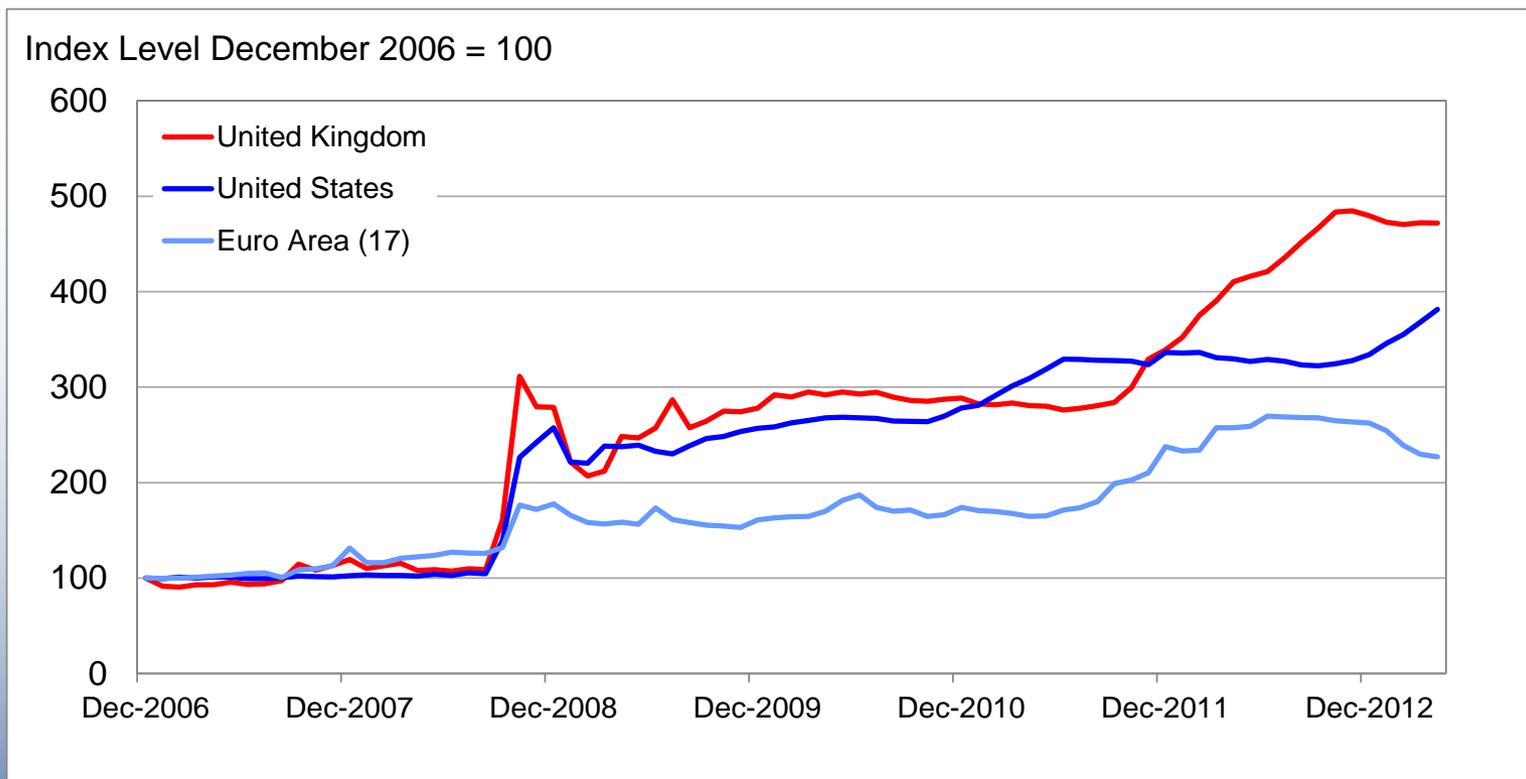
Note: Core PCE Inflation Rate is the percent change in the Core PCE from one year earlier

Source: BEA, Federal Reserve Board, NBER / Haver Analytics

Figure 10

Central Bank Assets in the United States, the United Kingdom and the Euro Area

December 2006 - April 2013



Source: Bank of England, European Central Bank, Federal Reserve Board / Haver Analytics

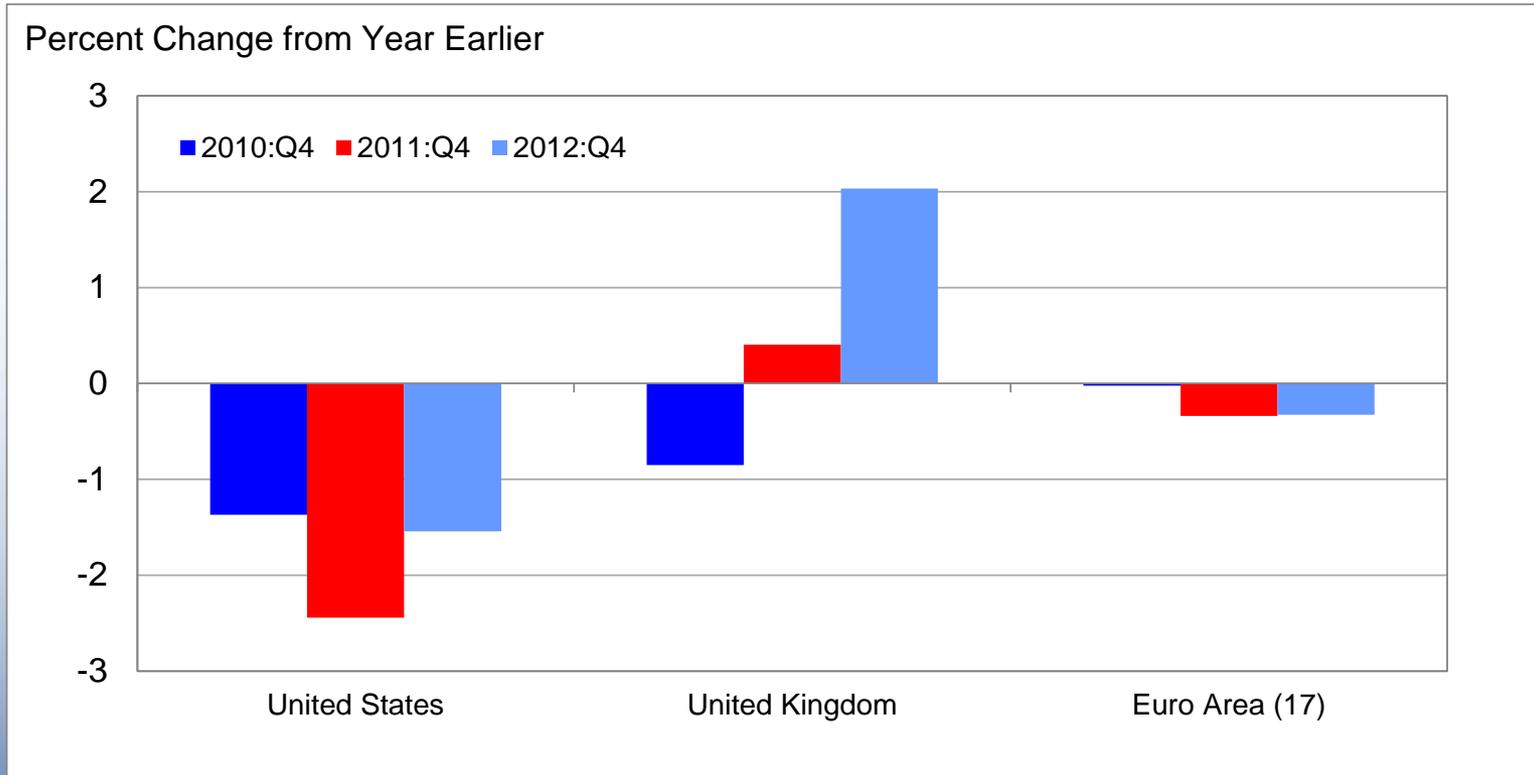
LSAPs and Improving Economy

- Unemployment rate is currently 7.5 percent – down from 7.8 percent last September
- Employment growth averaged over 200,000 jobs per month over the last three months
- But the employment-to-population ratio remains low – so some of the improvement in the rate is a result of workers leaving the labor force
- Need real GDP growth faster than the 2 percent we have been averaging in order to get more significant improvement in labor markets

Figure 11

Growth in Real Government Spending in the United States, the United Kingdom and the Euro Area

2010 - 2012



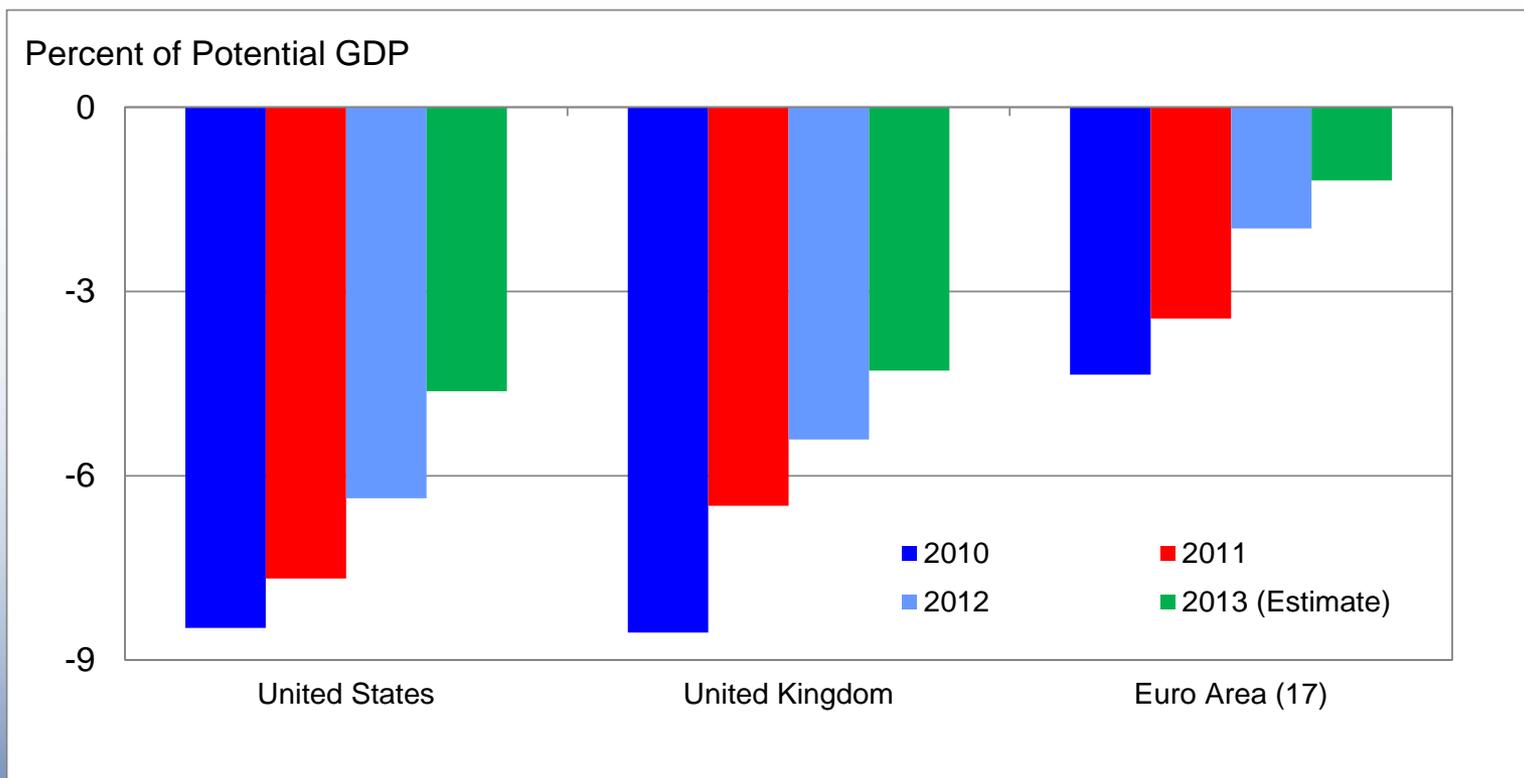
Note: Includes only government consumption expenditures.

Source: BEA, Eurostat, Office for National Statistics (U.K.) / Haver Analytics

Figure 12

Estimated General Government Structural Budget Balance

2010 - 2013



Note: For the Euro area, 2012 is also based on estimates of the budget balance for some countries

Source: IMF, World Economic Outlook Database

Concluding Observations

- The economy continues to gradually improve
- Accommodative monetary policy has been effective in interest-sensitive sectors, and partially offset by headwinds
- Long-term sustainable fiscal policy is important, but timing is an issue
- The timing and speed of restraint should depend on how the economic recovery progresses