"Implications of Fiscal Austerity for U.S. Monetary Policy"

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It is a great pleasure to be invited to participate in the Global Interdependence Center's conference on central banking. This continues to be a period requiring unusual policy actions – even experimentation – at central banks around the world. So it is important to understand the forces affecting policymaking as well as the impact of the policies, both domestically and internationally.

I always begin my talks by noting that these remarks reflect my views, not necessarily those of my colleagues on the Federal Reserve's Board of Governors or the Federal Open Market Committee (the FOMC). That is always the case, but I want to emphasize it today given my topic – the implications of fiscal austerity for monetary policy. This is a matter of great debate in most developed economies, as governments contend with relatively high debt burdens – at least by recent

historical standards – as well as the after-effects of a deep recession, and a painfully slow recovery. Certainly fiscal matters are the subject of intense debate in the United States.

Of course, much of the discussion – and many of the headlines – about fiscal austerity emanate from Europe. But, when we total up the cuts in *state and local* government spending and employment, the cuts in *federal* government spending and employment, and recent tax policy, we actually see that U.S. fiscal policy has been quite contractionary for several years now – beginning well before the recent payroll tax increase and the reductions in fiscal spending mandated by the federal sequester.

Unlike some of its counterparts around the world, the U.S. central bank has a dual mandate, covering both inflation and employment. So it is important when pursuing our mandate and shaping our policy to consider all the factors that affect the economy. Fiscal policy is one such factor. For instance, contractionary fiscal policy will in the near term place downward pressure on inflation and upward pressure on unemployment.

Currently the personal consumption expenditures or PCE inflation rate, which the Federal Reserve chose as the measure for its inflation goal a year ago, is about 1.0 percent. This is well below our 2 percent target. And the unemployment rate is 7.5 percent, which while lower than many other countries remains well above most estimates of U.S. "full employment."

It is critically important that the United States achieve a balanced and sustainable framework for government spending, but the timing is important. For example, making cuts too quickly to restore balance to the federal budget deficit will have a dampening effect on near-term growth and the recovery, and as such will push the economy further from a state that achieves both elements of the Fed's dual mandate.[1]

As I mentioned a moment ago, fiscal policy is just one of the many factors that the Federal Reserve considers in policymaking, but one can see how the central bank – pursuing its dual mandate – would be likely to adopt a more accommodative monetary policy stance if government spending were contracting in the midst of an economic recovery. Again, timing is key – long-term budget sustainability is vital, but decisions to front-load or back-load cuts in spending, or increases in taxes, have implications for the current stance of monetary policy.

Of course, some observers and indeed policymakers have criticized the degree of monetary accommodation in the United States as excessive. However, when we look at the data on outcomes in the economy to date, I see it differently. The outcomes could lead one to argue that policy has not been *sufficiently* accommodative. Inflation is below target and unemployment is above target, and based on the summary of economic projections (or "SEP") – which is published by the Federal Reserve and summarizes the economic forecasts of FOMC members – this condition is likely to persist for several more years.

At least part of this "miss" on inflation and employment outcomes can be attributed to the emergence of more fiscal restraint than might have been expected. You may recall that the federal sequester was originally designed to pose such an unpalatable outcome that all involved would prefer to reach an agreement on a more balanced fiscal approach. Unfortunately, that has not been the result. By definition, the increased fiscal austerity in the U.S. has weakened the outlook for near-term GDP growth, since government spending is a component of GDP.

To be sure, the progress of the economic recovery to date has been frustrating. And, despite the presence of significant headwinds – fiscal, financial, and otherwise – some have suggested that the slow recovery proves that recent monetary policy actions have been ineffective. However, contrary to what these observers claim, I would argue that the "miss" on outcomes is *not* evidence of monetary

policy ineffectiveness. In fact, in the sectors of the economy that are likely to be most responsive to lower interest rates, like housing and consumer durables, recent growth has been quite rapid. Contrary to the notion that policy has not succeeded, I would actually say that monetary policy has been quite effective in offsetting the contractionary effects of recent fiscal policies.

Fiscal Policy and the Recovery

As everyone here probably knows, the overall growth rate of real U.S. GDP during this recovery has been quite slow – averaging roughly 2 percent at an annual rate. Growth has also been slow relative to the growth that occurred during the most recent economic recoveries in the U.S. However, looking at overall GDP growth is only part of the story. Looking more closely at the components of real GDP reveals differences, and provides more perspective on the U.S. economy's tepid recovery.

Figure 1 shows growth in real final sales to private domestic purchasers. Essentially this is just the consumption and investment components of GDP (household and firm spending), net of inventory accumulation. It tries to capture the growth in domestic spending not attributed to government spending or to the foreign sector.

Over the past three years, real final sales to private domestic purchasers have been quite strong, reflecting particular strength in consumer durables and residential investment[2] – the most interest-sensitive sectors. With household and firm spending relatively strong, other sectors of the economy must account for the slow growth in overall GDP.

Figure 2 adds real final sales to all domestic purchasers to Figure 1, so the difference between the two lines is attributable to government spending. This measure has only been growing at a rate a little below 2 percent over the past three years. In short, while household and firm spending has been

relatively robust, it has been offset by a fiscal headwind – reduced government spending – netting out to only tepid overall growth.

Figure 3 shows the growth in government spending. Clearly, over the past three years the growth rate has been mostly negative, so real government spending has brought down the GDP total. This is in contrast to the earlier period, during the recession, when government spending was actually an offset to the weakness in the private sector. During that period there was federal stimulus money, and federal funding for state and local governments designed to help them better "weather the storm."

Figure 4 shows another way to measure the impact of government spending on economic growth – the percent contribution of government spending to the percent change in real GDP. Recently, the increase in real GDP includes a sizable negative contribution from reductions in government spending.

Figure 5 splits government spending into the federal component, and the state and local component. State and local spending has been weak over the entire recovery, although as the economy has recovered and state and local governments have seen more tax revenue, it has become much less of a headwind than earlier in the recovery. On the other hand, federal spending has recently fallen sharply and is likely to continue to be a source of weakness in the GDP accounts, given the federal sequester.

Historically speaking, this pattern is unusual during economic recoveries. Figure 6 indexes government spending at the trough of the recession to 100 for the current and previous three recoveries. This recovery has been unusual in that government spending is not normally a significant source of headwind as the economy recovers – in fact usually the opposite is true.

Consider the 1982 recovery – the last time we had a recession where the unemployment rate reached 10 percent. Government spending by this stage of the recovery had increased by 20 percent,

one reason that particular recovery was strong. By contrast, during this recovery real government spending has declined by more than 5 percent over the 15 quarters of the recovery.

Figure 7 shows *total* payroll employment and *private* payroll employment. The difference between the two reflects changes in government employment. During the recession, total payroll employment was less negative than private payroll employment, indicating the government sector was not shedding jobs at a time when the private sector was significantly downsizing. However, during the recovery period, private sector payroll employment has grown more rapidly than the total, reflecting the loss of government jobs that has persisted over the recovery.

In sum, fiscal restraint during the recovery has been notable and naturally has factored into the recovery's pace. While the sectors that are sensitive to monetary policy have responded to the Fed's accommodative policy actions, the results have not fully offset the headwinds, fiscal and otherwise, that we have seen. The overall result has been economic growth around 2 percent, and only a very gradual improvement in labor markets.

Fiscal Restraint and Inflation

The unemployment rate is about 7.5 percent – at least 2 percentage points above my estimate of the U.S. "full employment" rate. Add to this the recent U.S. *inflation* experience and the other factors I have been discussing, and it seems to me that highly accommodative monetary policy is currently appropriate.

Despite concerns expressed by some that increases in the Federal Reserve balance sheet may be inflationary in the near term, the inflation rate remains well below target nearly five years after our balance sheet expanded significantly. Make no mistake, in many situations such balance sheet

activity would be inflationary, but the fact that it has not been underlines how challenging the recent financial crisis, recession, and slow recovery have been.

Figure 8 provides total and core PCE inflation. Core PCE inflation has remained below 2 percent since December 2008 and currently is only 1.1 percent, close to the low for the last five years. Total PCE inflation is slightly below 1 percent, at 0.97 percent.

Indeed, the level to which the inflation rate has fallen would actually be of some concern in the event that the economy was hit by a negative shock. Such a situation might echo the historical experience of Japan, where low rates of inflation were not addressed and a significant negative shock caused Japan to experience deflation, which has been quite difficult to reverse. In the U.S. there is no evidence that inflation expectations have fallen, despite the actual experience of persistently undershooting the Fed's 2 percent target. However, remaining at such a low rate of inflation rate does increase the risk that a negative shock could alter the stable inflation expectations that we have experienced.

Figure 9 shows one reason why this is a concern. It plots the real interest rate as the difference between the 3-month Treasury rate and the year-over-year core PCE inflation rate. In effect, this assumes that inflation expectations equal the past year's core PCE inflation rate. Since the 3-month Treasury rate has remained very close to zero for more than four years, the movements in the real rate must primarily reflect changes in the other part of the equation – the inflation rate. Importantly, as the inflation rate falls, the real interest rate *rises*. Higher real interest rates make it more expensive to borrow, after controlling for changes in inflation. Japan has been an extreme example of this dynamic, given that deflation has caused the real interest rate to remain positive despite a weak economy and falling prices.

In sum, the longer we in the U.S. remain so far below our 2 percent target, the greater the risk that inflation expectations could fall and real interest rates rise. In part to offset this risk, the Fed has conducted large-scale asset purchases that increase its balance sheet.

Balance Sheet Implications

Figure 10 shows central bank assets in the United States, United Kingdom, and the Euro area. Each central bank has expanded its balance sheet, with the U.K. and the U.S. being particularly active.

The U.S. Federal Reserve has seen a renewed increase in the size of its balance sheet, starting in the fall of last year, reflecting the new program of open-ended asset purchases. This latest program has helped keep prevailing interest rates low, so that housing and consumer durables can continue to support the expansion and so we make further progress on both elements of the Fed's dual mandate (inflation and employment).

We have seen a gradual improvement in labor markets, in part as a result of these actions. The unemployment rate was 7.8 percent in September when we began the program, and is currently 7.5 percent. Employment growth averaged about 150,000 jobs per month in the three months ending in September; then for the most recent three months (February through April) employment growth averaged over 200,000 jobs per month. But despite modest increases in employment in recent months, the employment-to-population ratio remains low.

This last observation carries the more ominous implication that, while there has been improvement in labor markets, much of the improvement in the unemployment *rate* is just a result of workers leaving the labor force. More significant improvement in the employment picture will require growth in real GDP that is faster than the 2 percent we have been averaging.

As I noted earlier, restrictive fiscal policy has had an impact on near-term economic growth during the recovery. As Figure 11 shows, cuts in real government spending in the United States over the past three years have been quite large. In fact, the cuts in government spending in the United States have been much larger in percentage terms than in the U.K. or the Euro area, where fiscal austerity has received more attention. Fiscal restraint is one of the headwinds that we factored into monetary policymaking, framed of course by our mandates from Congress.

While Figure 11 considers only government spending, Figure 12 presents a broader measure of fiscal austerity, by including the revenue side and adjusting for the business cycle. The chart shows the impact of changes in taxes as well as government spending, after controlling for economic growth (removing the impact of the business cycle). Looking at the change in the general government structural budget balance[3] relative to potential GDP over the period 2010 to 2013, the degree of fiscal austerity is fairly similar across the U.S., U.K., and Euro area.

Given the additional restraint imposed by the federal sequester, the United States is likely to once again be a leader in cutting government spending. The Federal Reserve should, and will, continue to consider the likely state of fiscal policy, like many other economic factors, in making monetary policy.

Concluding Observations

The U.S. economy has continued to gradually improve. Labor markets have also slowly improved. The progress has been in part the result of the accommodative monetary policy. While household and firm spending has grown relatively rapidly, it has been partially offset by headwinds including cuts in government spending – resulting in only modest overall economic growth.

Let me close by reiterating that a long-term sustainable solution for fiscal balance is absolutely in the country's interest. But timing is an issue. We have suffered a severe financial crisis, a deep recession, and a painfully slow recovery. Fiscal policy is obviously the jurisdiction of the legislative and executive branches of government, but given the economic realities I would urge policymakers to consider scenarios where some elements of fiscal rebalancing take effect only after the economy has more fully improved, and the possibility of a less restrictive fiscal stance until that time.

Thank you.

NOTES:

[1] Some would observe that much of the current federal budget deficit is cyclical, not structural – that simply moving to full employment would eliminate a significant share of the budget deficit.

[2] Residential investment has grown strongly over the last six quarters; prior to that its performance was more mixed.

[3] The structural budget balance refers to the general government cyclically adjusted balance adjusted for nonstructural elements beyond the economic cycle. These include temporary financial sector and asset price movements as well as one-off, or temporary, revenue or expenditure items. The cyclically adjusted balance is the fiscal balance adjusted for the effects of the economic cycle; see, for example, A. Fedelino. A. Ivanova and M. Horton "Computing Cyclically Adjusted Balances and Automatic Stabilizers" IMF Technical Guidance Note No. 5, http://www.imf.org/external/pubs/ft/tnm/2009/tnm0905.pdf.