Charles I Plosser: Some observations on fiscal imbalances and monetary policy

Speech by Mr Charles I Plosser, President and Chief Executive Officer of the Federal Reserve Bank of Philadelphia, at The Philadelphia Fed Policy Forum: "Budgets on the brink: perspectives on debt and monetary policy", Philadelphia, 2 December 2011.

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The views expressed today are my own and not necessarily those of the Federal Reserve System or the FOMC.

Introduction

Good morning and welcome to the Philadelphia Fed Policy Forum. We are delighted you could join us today. The topic for our conference is both important and timely: "Budgets on the Brink: Perspectives on Debt and Monetary Policy". I look forward to today's presentations and discussion, but as the host for today's program, I am going to take the opportunity to share some of my thoughts on the fiscal situation facing many countries, including our own. Of course, these are my views and do not necessarily represent those of the Federal Reserve Board or my colleagues on the Federal Open Market Committee.

The challenge of fiscal imbalances for the economy

During the past year, we have witnessed the ongoing saga of governments, both in Europe and in the U.S., as they struggle with large deficits and soaring public debt, which are the result of unsustainable fiscal policies. Financial markets have become increasingly skeptical about whether the political process can come to grips with the problems. And so far, this skepticism appears to be wholly justified. Politicians continue to engage in protracted debates over who will bear the burden of the substantial adjustments needed to put fiscal policies back on a sustainable path. In my view, these prolonged debates have detrimental effects on economic growth, in part, because of the uncertainty they impose on consumers and businesses.

Given the magnitude of the fiscal shortfalls in many countries, the way in which fiscal discipline is restored will have profound implications for some time to come. Will there be higher taxes on productive investments by the private sector and higher taxes on wage earners – which would discourage both investment and work effort? Or will there be cutbacks on government purchases of goods and services from certain industries, such as aerospace and defense, or cutbacks on entitlements that would affect health care and social insurance? Or will a viable fiscal plan combine various types of tax increases and spending cuts? Until the path is chosen, uncertainty encourages firms to defer hiring and investment decisions and complicates the financial planning of both individuals and firms. The longer it takes to reach a resolution on a credible plan to reduce future deficits, the more damage is done to the economy in the near term.

The cause of the current fiscal crisis is sometimes attributed to cyclical factors and the magnitude of the recent global recession. It is certainly true that the financial crisis and the policy choices made by governments to deal with the ensuing recession have caused a significant deterioration in fiscal balances and debt levels in many countries. For example, in the U.S., the federal budget deficit is now about 9 percent of gross domestic product, up from less than 2 percent in 2007. However, the underlying trends that are at the root of unsustainable fiscal deficits in many countries, including the U.S., have been in place and known for some time. Even after cyclical effects play out, many countries will have large structural budget deficits. In this sense, the financial crisis and recession have simply exacerbated the underlying problems and perhaps moved up the day of reckoning. In some cases, such as Greece, that day has come. Market participants have begun to question the solvency of governments and their ability to honor their sovereign debt obligations. In Europe, the doubts have greatly complicated the political problems as various countries debate the question of “who pays” for the anticipated bad debts of individual countries. Here too, the protracted nature of the political debate creates uncertainty, which undermines economic growth and exacerbates the crisis. Indeed, the argument offered by many that preventing Greek default would prevent the crisis from spreading has proven false.

The interaction of monetary policy and fiscal policy

The fiscal challenges are daunting, yet they also have implications for monetary policy. The policy choices made during the recent global recession have made these implications even more complex and potentially dangerous. But the appropriate relationship between monetary and fiscal policy is not a new topic. Indeed, our very first Policy Forum in 2001 was organized around three questions for monetary policymakers, one of which was how should monetary and fiscal policy interact?

It is widely understood that governments can finance expenditures through taxation, debt, or printing money. If public debt levels are high and rising, and fiscal policymakers are reluctant to make the hard choices of cutting expenditures or increasing taxes, history suggests that governments often resort to the printing press to try to escape their budget problems. Yet we all understand that this option is a recipe for creating substantial inflation. Indeed, it is often a path toward hyperinflation. Failure to resolve underlying fiscal imbalances combined with rising inflation means nominal funding requirements to close the budget gap keep growing, requiring ever more money to be created, and causing inflation to rise even further. It is a cycle any nation should seek to avoid.

In addition, inflation is a hidden tax on holding nominal assets, and when it is unanticipated, it can have significant consequences that redistribute wealth from creditors to debtors. The near-term effects of money creation often appear to be positive, while the undesirable consequences only become apparent over time. While money creation results in lower nominal interest rates and perhaps a modest boost to real activity in the short run, over time, it results in higher inflation and higher nominal interest rates and ultimately requires painful efforts to restore price stability. Awareness of these long-term consequences of succumbing to the temptation of excessive money creation is the basic reason that over the last half of the 20th century, there has been a strong movement to establish and maintain independent central banks in country after country. It is simply good governance and wise economic policy to maintain a healthy separation between those responsible for tax and spending policy and those responsible for money creation.

Another widely acknowledged basic tenet of sound central banking is the wisdom of maintaining a low and stable inflation rate. Price stability contributes to the economy’s growth and employment prospects in the longer term and helps to moderate the variability of output and employment in the short to medium term. Price stability allows the economy to function in a more efficient and more productive manner by giving individuals and businesses more confidence that the purchasing power of their money will be maintained over time. Central banks are uniquely positioned to achieve price stability. The economic costs of failing to do so can be quite high.

Despite the well-known benefits of maintaining price stability, there are increasing calls to abandon this commitment in both Europe and the U.S. Central banks are under increasing pressure to act, both because fiscal authorities have been unable to make credible commitments to maintain fiscal discipline and because central banks have been willing to engage in actions that stray into the realm of fiscal policy – for example, purchasing assets of the housing sector. This is a disturbing trend that risks undermining the independence of the central bank to control monetary policy and its ability to preserve a credible commitment to price stability.

Why monetary policy and fiscal policy should remain separate

As I mentioned, governments can finance expenditures through only three options: taxes, debt – which is really just a euphemism for future taxes – or money creation, which leads to the hidden tax of inflation. Central bank independence allows monetary policymakers to pursue price stability without the political pressures to finance government expenditures or otherwise engage in fiscal actions constitutionally reserved for the fiscal authorities. In a classic paper[1], recent Nobel Prize winner Thomas Sargent and his co-author Neil Wallace showed that when the fiscal authority chooses an unsustainable fiscal policy path, in which debt to GDP ratios are rising and proposed budgets don't generate enough future surplus to offset current deficits, seigniorage is the only way for the government to achieve intertemporal budget balance. In other words, the central bank must eventually monetize the debt – whereby high rates of inflation devalue longer-term government debt. Today, one of our speakers, Eric Leeper, will discuss his work on how long-run fiscal stress can undermine monetary control of inflation. In such an environment, monetary policy is no longer independent but becomes subservient to unsustainable fiscal policy.

There are those who argue that this is exactly what monetary policy should be doing today: creating higher inflation to solve the fiscal failures by devaluing the outstanding government debt. The inflation tax would transfer wealth from those that have lent money to the government in good faith – the investors in sovereign debt – to the government itself. I am deeply skeptical of such a strategy. In my view, inflation is a blunt and inappropriate instrument for assigning winners and losers from profligate fiscal policy. Moreover, history has shown that once inflation is unleashed, it is not always easy to bring it back down, especially if the central bank loses the public's confidence and damages the credibility of its commitment to return to price stability. The continuing fiscal disarray may also lead the public to believe that the government's only near-term strategy is to monetize the debt. Even if the central bank resists, expectations of future inflation could become unanchored and inflation could rise through no fault or consequence of central bank action or intent.

Unfortunately, from my perspective, the Fed and other central banks have already embarked on a path that has blurred the distinction between monetary policy and fiscal policy. These steps were undertaken with the sincere belief that they were absolutely necessary to address the challenges posed by the financial crisis. For example, the Fed established credit facilities to support particular asset classes, such as commercial paper and asset-backed securities, and in November 2008, the Fed announced it would begin purchasing housing agency mortgage-backed securities and agency debt to increase the availability and reduce the cost of credit in the housing sector. These types of credit programs target particular market sectors and thereby alter the allocation of credit across markets, reducing funding costs for some sectors and likely raising costs for others. These programs departed from the usual way the Fed implements monetary policy through buying and selling U.S. Treasury securities, an activity that is generally neutral across markets. When the Fed engages in targeted credit programs that seek to change the allocation of credit across markets, I believe it is engaging in fiscal policy. Instead of the central bank engaging in this credit policy, the federal government could carry out these transactions by issuing Treasury debt to support lending to the targeted markets or firms. In fact, the fiscal authorities frequently undertake such actions – think of "green energy" loans, small business loans, and subsidized home mortgages. Such credit allocation decisions belong with the fiscal authorities, not the central bank. Even the recent maturity extension program, or "Operation Twist" as it is sometimes called, involves selling short-term Treasuries and buying longer-term Treasuries – an action that could just as well have been conducted by the U.S. Treasury.

[1] Thomas Sargent and Neil Wallace, "Some Unpleasant Monetarist Arithmetic", Federal Reserve Bank of Minneapolis *Quarterly Review*, 5 (Fall 1981), pp. 1–17.

Once a central bank ventures into conducting fiscal policy, it may find itself under increasing pressure from the private sector, financial markets, or the government to use its balance sheet to substitute for other fiscal decisions. This pressure can threaten the central bank's independence in conducting monetary policy and thereby undermine monetary policy's effectiveness in achieving price stability.

I have long argued for a bright line between monetary policy and fiscal policy, for the independence of the central bank, and for the central bank to have clear and transparent objectives. Decisions to grant subsidies to particular market segments should rest with the fiscal authorities – in the U.S., this means the Congress and the Treasury Department – and not with the central bank. Should the fiscal authority ask the central bank to engage in lending outside of its normal operations, the fiscal authority should be willing to exchange government securities for the nongovernment assets that would accumulate on the central bank's balance sheet as a result. This type of swap would ensure that the full authority and responsibility for fiscal matters remained with the Treasury and Congress.

Congress has mandated the goals of monetary policy to promote long-run price stability, maximum employment, and moderate long-term interest rates. Asking monetary policy to take on the role of fiscal policy undermines the ability to achieve this congressional mandate. Central banks and monetary policy are not and cannot be real solutions to the unsustainable fiscal paths many countries currently face. Proponents who believe otherwise are skating on thin ice. The only real answer rests with the fiscal authorities and their ability to develop credible commitments to sustainable fiscal paths. It's a difficult and painful task to be sure, but a monetary solution is a bridge to nowhere at best, and the road to perdition at worst – a world of rising and costly inflation.

Once again, I want to thank everyone for coming today. I am confident that it will be a fascinating program. So now that I've told you what I think, let's get stared and hear from the real experts.