

Donald L Kohn: Interactions between monetary and fiscal policy in the current situation

Speech by Mr Donald L Kohn, Vice Chairman of the Board of Governors of the US Federal Reserve System, at the Conference on Monetary-Fiscal Policy Interactions, Expectations, and Dynamics in the Current Economic Crisis, Princeton University, Princeton, New Jersey, 23 May 2009.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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Our current economic situation has altered some of the usual interactions between monetary and fiscal policy. One change regards the relative effects of monetary and fiscal policy. The depth and persistence of economic weakness has meant that traditional monetary policy – the target for the federal funds rate – has become constrained from easing as much as might be desirable under the circumstances, and, as a consequence, the target federal funds rate is anticipated to remain near zero for some time. But as a result, fiscal stimulus has potentially become more effective in boosting economic activity than it usually would be.

Another change involves the potential for monetary policy actions to have greater fiscal implications than usual. The Federal Reserve has extended both its open market operations and lending programs in unprecedented ways to ease financial conditions and to help revive economic activity. In our open market operations, we have embarked on large-scale purchases of intermediate- and long-term Treasury securities, agency debt, and agency-guaranteed mortgage-backed securities (MBS) in order to put further downward pressure on borrowing costs, greatly increasing the degree of maturity transformation on our balance sheet. In addition, our traditional liquidity operations have been extended to include new borrowers and new markets, with the potential for greater credit risk than usual.

In my view, our nontraditional policy actions have been necessary to avert a far worse economic outcome, and they remain consistent with the traditional goals and principles of monetary policy. Moreover, as I will be discussing, we have structured these policies with the aim of accomplishing our objectives with few, if any, fiscal consequences. I will conclude with some thoughts about the transition back toward more typical monetary policy as the economy and financial markets improve.¹

Fiscal policy when monetary policy is at the zero lower bound

During normal economic circumstances, most economists do not view expansionary fiscal policy as an especially effective tool for producing a sustained increase in aggregate demand and in resource utilization. Ordinarily, financial market participants would expect monetary policy to react by increasing the target federal funds rate over time to keep output near potential and inflation near its desired level. Thus, the enactment of a sustained fiscal expansion would trigger an increase in expected short-term interest rates and hence long-term interest rates. The higher long-term rates would also tend to reduce asset values and boost the foreign exchange value of the dollar. As a result, any initial increase in aggregate

¹ The views presented here are my own and not necessarily those of other members of the Board of Governors or the Federal Open Market Committee. Eric Engen, David Reifschneider, and John Roberts of the Board's staff contributed to these remarks.

output and employment from the fiscal expansion would be soon crowded out by reductions in household spending, business investment, and net exports.²

But in the current weak economic environment, a fiscal expansion may be much more effective in providing a sustained boost to economic activity. With traditional monetary policy currently constrained from further reductions in the target policy rate, and with many analysts forecasting lower-than-desired inflation and a persistent, large output gap, agents may anticipate that the target federal funds rate will remain near zero for an extended period. In this situation, fiscal stimulus could lead to a considerably smaller increase in long-term interest rates and the foreign exchange value of the dollar, and to smaller decreases in asset prices, than under more normal circumstances. Indeed, if market participants anticipate the expansionary fiscal policy to be relatively temporary, and the period of weak economic activity and constrained traditional monetary policy to be relatively extended, they may not expect any increase in short-term interest rates for quite some time, thus damping any rise in long-term interest rates. Moreover, if the initial boost to aggregate spending from fiscal stimulus raises inflation expectations, then real short-term interest rates would tend to decline, given that the nominal short-term interest rate is constrained at the zero lower bound. All told, the result is likely to be considerably less of the usual crowding out of fiscal stimulus in these circumstances, thereby increasing the effectiveness of fiscal policy to boost the level of aggregate economic activity in the short to medium term.

This scenario is supported by simulations using the Federal Reserve staff's FRB/US model, assuming all agents have rational expectations.³ For example, suppose the level of federal government purchases is increased permanently by 1 percent of gross domestic product (GDP). Under normal circumstances, the fiscal spending multiplier – that is, the percentage response of real GDP to the boost in government spending – starts out at about 1 but then quickly falls to zero as long-term interest rates rise so that private spending and exports decline. However, if financial market participants anticipate that the federal funds rate will remain at zero for an appreciable period of time following the hike in government spending, the simulated short-run fiscal multiplier rises to 1.3 for some time. Model simulations also indicate that the fiscal spending multiplier may rise even further – to around 2 – if the fiscal stimulus is expected to be temporary and to last no longer than the period when monetary policy holds short-term interest rates at the zero lower bound.⁴

To be sure, greater-than-usual uncertainty surrounds estimates of the size of the fiscal multiplier under current circumstances, and its magnitude could be somewhat smaller than suggested by these model simulations. With lenders unusually cautious, household and business spending may react less than would normally be expected to low real interest rates because tight nonprice credit terms are restricting access to borrowed funds. Also, the above-normal levels of uncertainty faced by households and firms could damp the responsiveness of consumption and investment spending to the boost in household income and business earnings generated by the fiscal stimulus. Finally, any increase in uncertainty about the longer-term trajectory of government borrowing could raise term premiums.

² Of course, sustained changes in fiscal policy may have supply-side implications that affect the long-run level of potential output, and hence actual gross domestic product. Except to the extent that these long-run changes alter the equilibrium real rate of interest, however, they have only minor implications for monetary policy.

³ In the FRB/US model, about 40 percent of households are estimated to be rule-of-thumb consumers, implying that they generally spend most of their current income. The remaining households are life-cycle consumers, implying that their spending decisions are influenced by their expected permanent income rather than their current income. However, these consumers are nonetheless relatively sensitive to expected changes in income over the next several years because they are assumed to discount future income at a high rate, reflecting its uncertain nature.

⁴ These basic results are also borne out by simulations using the Federal Reserve staff's estimated dynamic stochastic general equilibrium (DSGE) model of the U.S. economy, EDO, and its calibrated multicountry DSGE model, SIGMA.

Nontraditional monetary policies

Current economic and financial conditions have not only changed the potential effectiveness of fiscal stimulus, but they also have altered the way in which monetary policy seeks to support economic activity and foster price stability. With the target federal funds rate effectively at zero, our traditional monetary policy tool can no longer provide additional stimulus to the economy. Moreover, heightened uncertainty and pressures on intermediary balance sheets have impaired the usual channels of credit intermediation. In these circumstances, the Federal Reserve has provided additional monetary stimulus by easing financial conditions more directly through its interventions in a variety of financial markets. In effect, we have stepped up our intermediation by making large volumes of asset purchases and loans, which have been associated with a very substantial increase in bank reserves on the liability side of our balance sheet.

In open market operations, we have announced our intention to purchase up to \$1.75 trillion in longer-term Treasury notes and bonds, agency debt, and agency MBS during this year. This program is intended to stimulate real economic activity by holding down intermediate- and long-term interest rates by bringing down the term premium on these securities – a mechanism that is distinct from the traditional channel whereby a shift in the stance of monetary policy affects longer-term yields by changing the expected path of short-term interest rates.⁵ The preliminary evidence suggests that our program so far has worked; for example, our announcements regarding the large-scale asset purchase program coincided with cumulative restraint on the average level of longer-term interest rates, perhaps by as much as 100 basis points by some estimates.

That the Federal Reserve is holding a portfolio of long-term assets on its books is not especially unusual – prior to the onset of the financial crisis, we held about \$150 billion of Treasury securities with maturities of more than five years. Moreover, we have long been authorized to purchase securities issued by government-sponsored enterprises (GSEs). However, in the current circumstance, the scale of our intended holdings, and the related expansion of the Fed's liabilities to acquire these assets, is unprecedented. Holding such a large portfolio of long-term assets does expose the Federal Reserve, and thus the taxpayer, to potential losses as short-term interest rates rise. We could end up financing our holdings of some low-yielding long-term assets with more expensive short-term liabilities or, we might have to sell some of these assets at a loss as long-term rates rise. But in gauging the potential cost to taxpayers associated with future interest rate movements, several considerations are important to keep in mind. First, some of the Treasury and GSE debt that we are acquiring will run off over the next few years without any need for outright sales, as will some of the MBS as individuals sell or refinance their homes. Second, the yield curve currently has a steep upward slope. Accordingly, we are now earning an abnormally high net rate of return by funding our acquisition of long-term assets with almost zero-cost excess reserves – and this relative yield relationship is likely to last for some time. Thus, in judging the potential budget cost over time, any possible future interest-rate-related losses need to be balanced against the current elevated level of our net interest income. Third, our purchases of long-term securities are boosting economic activity and, in the process, increasing government tax receipts relative to what they would have been in the absence of such purchases.⁶ All in all, although we have now taken more interest rate risk onto our

⁵ The mechanism for this effect seems to work, in part, through the habitat preference of investors for long- and short-term debt. Moreover, through indirect effects on other financial markets, LSAPs can also be effective in reducing interest rates on many other types of household and business credit.

⁶ Although any calculation of the effect of our asset purchases on the economy is highly uncertain, estimates from our models suggest that nominal GDP could be as much as \$1 trillion higher over the next several years than it would be without the large-scale asset purchase program. Such stimulus would not only significantly improve the economic welfare of our nation's citizens, but also could provide the federal government with as much as about \$175 billion in greater tax revenues than it would otherwise receive.

balance sheet than usual (at a time when the private sector wants to avoid this risk), that action may boost, rather than reduce, the cumulative net income of the Treasury.

Turning to our credit facilities, our usual lending through the discount window has been extended to new intermediaries – including primary dealers, money market mutual funds, and participants in securitization markets such as hedge funds and pension funds. And we have intervened more directly in severely impaired markets, such as those for commercial paper and securitized consumer and mortgage debt. We believe these interventions have been successful in supporting economic growth by bringing down interest rates on the instruments involved, preventing fire sales of assets by intermediaries that would otherwise not have access to liquidity, and facilitating new lending.

These unusual extensions of our lending facilities have raised concerns about the Federal Reserve taking on credit risk. While those concerns are understandable, I want to emphasize that we have taken a variety of steps to minimize credit risk in setting up the various nontraditional and temporary credit facilities that we have made available to a number of new borrowers. For almost all the loans we have made, we look first to sound borrowers for repayment and then to underlying collateral. Moreover, we lend less than the value of the collateral, with the size of the "haircuts" depending on the riskiness of the collateral and on the availability of market prices for the collateral. Some of our lending programs involve nonrecourse loans that look primarily to the collateral rather than to the borrower for repayment. In these instances, we typically have taken only the highest-quality collateral, and, in many cases, we have coordinated with the Treasury to have other sources available to absorb any losses that might nonetheless occur. An example of a program that relies importantly on monetary-fiscal coordination is the Term Asset-Backed Securities Loan Facility, whereby protection against credit risk takes the form of capital provided by the Treasury, using funds appropriated by the Congress for the Troubled Asset Relief Program.

To be sure, loans or credit protection offered in association with government help to stabilize individual systemically important institutions likely have higher credit risk than our more general liquidity facilities. But even in these few cases, which occurred under emergency conditions, we have taken steps to protect the Federal Reserve from credit losses and have asked the Treasury to take these loans off our balance sheet. To reduce the risk of future problems here, a new regulatory regime should be developed that will allow the U.S. government to address effectively at an early stage the potential failure of any systemically critical financial institution.

Finally, there is the question of whether the Federal Reserve has become involved in the inherently fiscal function of allocating credit to specific sectors of the economy. Because of the lack of liquidity, risk-taking, and arbitrage in markets, we have been forced to counter tight financial conditions through interventions in particular markets, which can have differential effects. But our actions have been aimed at increasing credit flows for the entire economy, and they have been effective in that regard. For example, our large-scale asset purchases of agency securities and agency-guaranteed MBS have helped mortgage markets, but they also appear to have put downward pressure on other long-term interest rates, as we expected. Similarly, our other efforts to supply liquidity to the financial system have been intended to be broad based, helping banks, investment banks, and money market mutual funds perform their intermediary functions and helping restart widely utilized securitization markets.

Both the Treasury and the Federal Reserve understand, and have acknowledged in the joint statement released on March 23, that it is important for the Federal Reserve to avoid credit risk and credit allocation.⁷ Our lender-of-last-resort responsibilities should only involve

⁷ Board of Governors of the Federal Reserve System and U.S. Department of the Treasury (2009), "The Role of the Federal Reserve in Preserving Financial and Monetary Stability: Joint Statement by the Department of the Treasury and the Federal Reserve," joint press release, March 23.

lending that is appropriately secured. Actions taken by the Federal Reserve should also aim to improve financial and credit conditions broadly and not to allocate credit to narrowly defined sectors or classes of borrowers, as any decisions to influence the allocation of credit is the role of fiscal policy. Moreover, I believe the essential role for an independent monetary policy authority pursuing financial stability, economic growth, and price stability remains widely appreciated. Indeed, the joint statement of the Treasury and the Federal Reserve also included an agreement to continue to pursue additional tools to control our balance sheet to reinforce our ability to conduct an independent policy in pursuit of our macroeconomic objectives – the final topic that I will discuss today.

Transition back to more traditional monetary policy

An important issue with our nontraditional policies is the transition back to a more normal stance and operations of monetary policy as financial conditions improve and economic activity picks up enough to increase resource utilization. These actions will be critical to ensuring price stability as the real economy returns to normal. The decision about the timing of a turnaround in policy will be similar to that faced by the Federal Open Market Committee (FOMC) in every cyclical downturn – it has to choose when, and how quickly, to start raising the federal funds rate. In the current circumstances, the difference will be that we will have to start this process with an unusually large and more extended balance sheet.

In my view, the economy is only now beginning to show signs that it might be stabilizing, and the upturn, when it begins, is likely to be gradual amid the balance sheet repair of financial intermediaries and households. As a consequence, it probably will be some time before the FOMC will need to begin to raise its target for the federal funds rate. Nonetheless, to ensure confidence in our ability to sustain price stability, we need to have a framework for managing our balance sheet when it is time to move to contain inflation pressures.

Our expanded liquidity facilities have been explicitly designed to wind down as conditions in financial markets return to normal, because the costs of using these facilities are set higher than would typically prevail in private markets during more usual times. Indeed, some of our emergency facilities – the Term Securities Lending Facility and the Primary Dealer Credit Facility – have already seen reduced use as funding markets have returned to more normal functioning. Managing the assets acquired under our large-scale asset purchase program will require a different set of techniques. As I have already noted, some portion of these assets will run off on their own. In addition, we can actively manage the asset levels down by selling the assets outright or on a temporary basis through reverse-repurchase transactions. Moreover, we could run off these holdings slowly while still raising the federal funds rate if we increased the rate paid on excess reserves held at the Federal Reserve. In principle, the rate paid on excess reserves should act as a floor on the federal funds rate; although recent experience suggests that it may not establish a hard floor, that experience has been influenced by the unwillingness of banks to arbitrage in size in the current circumstances when they are worried about their capital. Finally, as I've already noted, the Administration has said it will work with us and the Congress to get us an additional tool for absorbing reserves.

Conclusion

Experiences studied over a range of countries and periods of history tell us that central banks need a degree of insulation from short-term political pressures if they are to consistently foster the achievement of their medium-term macroeconomic objectives of price stability and high employment. This independence in the conduct of monetary policy has been supported by minimizing the fiscal implications of monetary policy operations. The Federal Reserve has attempted to maintain this separation while extending the range of our open market operations and discount window lending. But changing policy interaction and

greater cooperation between fiscal and monetary authorities have been an inevitable aspect of effective policy initiatives to meet our macroeconomic objectives in the current financial and economic crises. As the economic recovery takes hold, we will need to return to more normal modes of operation – a circumstance this central banker is very much looking forward to.