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Background paper for Panel 1: Getting out of the Downturn While Ensuring the Future--the U.S. Situation

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The U. S. Economic Situation

The U.S. economy is growing, but not very rapidly considering the depth of the recession. Over the second and third quarters GDP is estimated to have risen at an average annual rate of about 2 percent, and many forecasters are predicting a similar rate of expansion in the fourth quarter. This growth rate is about in line with or even a little below the rate of growth of the economy's productive potential, and therefore employment has been slow to recover and the unemployment rate has remained at an elevated level of 9-1/2 percent for some time.

Slow growth has occurred despite extremely accommodative monetary policy by traditional metrics. Both real and nominal interest rates are extraordinarily low, and reserves and liquidity are plentiful. Growth has been held back by the imperative for balance sheet repair by households, which found themselves with greatly diminished wealth as house prices declined, extraordinarily high debt levels incurred against previously rising house prices, and very uncertain job prospects. In addition, those borrowers dependent on banks and many securitization markets are facing much tighter credit availability as the financial sector itself deleverages and corrects the excesses of earlier years. Moreover, the US economy entered the recession with a huge overhang of houses and probably consumer durables that are only slowly being worked off, and the global character of the downturn has limited the scope for a rebound in exports. In addition, uncertainty remains quite high and confidence of both businesses and households very low. Mostly, that is a product of the depth and unusual character of the recession and slow recovery, but a lack of clarity on fiscal policy—discussed below—and on new regulations in finance and health care are probably adding to the headwinds. Finally, the traditional macroeconomic tools to foster faster growth are constrained: fiscal policy by the lack of a plan to deal with the long-run budgetary challenge of entitlements and demographics, and monetary policy by having short-term rates already at zero.

Growth should pick up as the steps being taken by households and financial institutions to bolster their financial positions bear fruit, but the acceleration in spending and associated decline in the unemployment rate are likely to be very gradual. Although structural factors—including enhanced unemployment benefits and the need to shift large numbers of workers to new industries--are probably contributing some to the high unemployment rate, most of the nearly 5 percentage point rise in the unemployment rate and substantial drop in output probably represents economic slack caused by the drop in demand. The influence of that slack can be seen the in the slowdown in the growth of compensation and the drop in inflation rates. Core CPI inflation has fallen from the 2 to 2-1/2 percent range that prevailed through much of the mid 2000s to less than 1 percent most recently on a twelve-month basis. Headline inflation has been much more variable, but it too has fallen substantially in the past few years. The fall in inflation has occurred despite longer-term inflation expectations being reasonably well anchored at higher levels, suggesting that conditions in labor and product markets have been very competitive. Under the circumstances of the gradual strengthening predicted, inflation is likely to remain quite low for some time—appreciably below the level of 2 or a little lower that Chairman Bernanke enunciated as a target recently.

A sluggish recovery and prolonged low inflation in the United States could have substantial costs. Among other things, as unemployment is prolonged, some cyclical unemployment could become structural as workers lose skills and attachment to the labor force. If inflation expectations begin to adjust downwards, real interest rates would rise, further damping an already weak recovery. And prolonged high unemployment could foster greater protectionist pressures in the United States.

The Policy Environment

Fiscal policy. Under these circumstances a textbook prescription for a more rapid emergence from the recession might well involve additional fiscal stimulus—temporary tax cuts and spending increases--to bridge the period until private balance sheets and confidence can sustain enough spending to return employment and production to higher levels. Although it looks increasingly likely that all the Bush tax cuts will be extended at least for a time and that consequently fiscal policy will be more supportive of growth than if some or all had expired, additional near-term stimulus is not likely at this point. Importantly, there is little support for it in the political process. This stems in part from deep skepticism that fiscal stimulus was effective at stimulating spending. The disappointing trajectory of the economy and the unemployment rate over the past year or so despite a fiscal package in early 2009 are feeding that skepticism. The counterfactual argument—it would have been even worse without that stimulus—has not proven convincing.

More fundamentally, the case for more near-term stimulus is undermined by the lack of a long-term path to fiscal sustainability. As is well known and understood, without major changes to the paths of spending and taxes built into current laws and commitments, the ratio of debt to GDP in the United States is on an unsustainable rising track, reaching dangerously high levels before very long. For the most part, this path is a product of demographics interacting with the promises made for retirement and medical care support and with the rising real cost of that medical care. To date, the political system has been unwilling to deal with this problem. The resulting lack of clarity about longer-run spending and tax regimes is contributing to economic uncertainty. In those circumstances, near-term stimulus, by adding to the level of the debt, makes the long-run problem more difficult and adds to uncertainty, which could well offset a good part, if not all of the near-term stimulative effect. And a higher level of debt would increase the tail risk, however small, of an adverse market assessment of the debt path for the economy, which would raise term and risk premiums on interest rates throughout dollar markets. With no path to sustainability, voting against proposals for near-term stimulus to support the economy is the only way lawmakers can demonstrate to their constituents that they are taking the long-run problems seriously.

Recent developments hold some promise for a more serious discussion of the choices facing the country on this issue and, perhaps, for beginning to come to grips with the difficult decisions that need to be made. Representatives of several bi-partisan groups have just published suggestions for dealing with the trajectory of the debt. The plans differ to some extent and their reception hasn't been good in some quarters, but they appear to have shifted the terms of the debate in constructive ways. For one, they have underlined the seriousness of the problem and the fact that stability will require very difficult choices and sacrifices—the country can not make good on all the promises its government has made and expectations for services and support without punishing and counterproductive levels of taxation. For another they have highlighted several potential sources for deficit reduction that might not be obvious to many citizens, such as tax expenditures and they have proposed combinations of tax base broadening and simplification together with reductions in marginal tax rates that should prove supportive of growth. And finally these reports have begun to shift the baseline and focus from current policy to the sustainable path. Those who object to particular aspects of the proposals are now expected to produce substitutes that deliver roughly the same result for the growth of government debt.

Still, the prospects for meaningful actions any time soon are not bright. And as a consequence the odds on what many have identified as the ideal fiscal pattern of stimulus now and meaningful committed restraint later remain low. The priority is likely and appropriately to remain on addressing the longer-run problem and until progress on that is in prospect, shorter-term stimulus will not be possible.

Monetary policy The Federal Reserve has emphasized in recent communications that it has a "dual mandate" for "maximum employment and stable prices" and that recent experience and its own forecast suggest that progress toward both these objectives is "disappointingly slow." With fiscal policy hamstrung, all the responsibility for boosting the return of the economy to its long-term potential and inflation back up to its longer-term objective has rested on monetary policy. Under current circumstances, both arms of the dual mandate call for easier monetary policy, and with short-term rates already effectively at zero, the Federal Reserve has begun a program to buy intermediate and longer-term Treasury securities.

These purchases are expected to work much as would a cut in short-term interest rates in more normal times. The latter tends to lower intermediate and long-term rates, reducing the cost of borrowed capital; raise equity and other asset prices; and reduce the foreign exchange value of the dollar. Easier financial conditions stimulate spending on domestically-produced goods and services--including through higher exports and lower imports--raising employment, reducing slack, and moving inflation up towards its target. The large scale asset purchases act more directly on intermediate and long-term rates, but otherwise should work through the same channels; in this regard they can be seen as an extension of “normal” monetary policy rather than a radical departure. In fact, financial conditions largely followed the script as markets anticipated the Federal Reserve’s announcement on November 3. Some of that easing has reversed since the Federal Reserve’s announcement, reflecting downward revisions to the expected quantity of purchases based on the announcement and the reaction to it, and other unrelated developments, including pressures in the Euro area and heightened geopolitical tensions. It is too early to judge whether easier financial conditions would lead to stronger spending. There are reasons to suspect that some of the normal channels of policy may not be as effective as they might be under other circumstances.

Of course in one respect the purchases are very different from an adjustment in the federal funds rate in that they are accompanied by extremely large increases in the excess reserves of the banking system. To date, however, the increases in reserves beginning in the fall of 2008 appear to have had little effect on the price or quantity of money or bank credit and hence little effect by themselves—over and above the effects of the purchases--on spending or prices.

Nonetheless, the actual and anticipated build up of reserves probably lies behind some of the concerns about the policy that have been recently voiced. Among those concerns is the potential for inducing more inflation than is optimal, despite the net decline in inflation since the balance sheet began to be expanded. In that regard the Federal Reserve will need to be alert to changes in inflation and inflation expectations that could threaten its price stability objective on the high side. To some extent, the doubts that the Federal Reserve will keep inflation to its target are linked to the unsustainable fiscal trajectory discussed earlier. The risk is that burgeoning federal debt will greatly exacerbate the political pressures on the Federal Reserve when it comes time to raise interest rates.

Another concern is that the purchases are distorting asset prices, and the unwinding of those distortions when policy is finally normalized could result in financial instability. In this regard, the purchases are intended to distort prices—to push them where they would not go in the absence of Federal Reserve action. When intermediate and long-term Treasury rates decline, investors look out the yield and risk curves for greater returns, easing financial conditions more generally and inducing an increase in spending. The authorities will need to carefully monitor risk-taking by regulated institutions and their capital levels to make sure they are robust to an unexpected reversal of yield relationships.

The International Context

In globalized financial markets, the effects of actions in one country to change yields and asset prices don't stop at national borders. As additional asset purchases came to be anticipated, the dollar has tended to weaken and asset prices abroad to rise in response to capital flows away from dollars, especially into those economies—largely emerging market economies—where demand is stronger, production much closer to potential, and interest rates higher. The resulting discomfort and protests, although aimed on the surface at the Federal Reserve's actions, reflect a difficult and deeper set of overlapping global issues.

First, global demand overall is well below global potential. That means countries tend to see themselves in a zero-sum game, fighting over a pie that's not sufficiently large for all to be sated. The shortfall in global demand isn't surprising in the wake of widespread banking and debt problems, but it does set up a dangerous situation that could invite beggar-thy-neighbor policies instead of constructive efforts to contribute to a strong and better balanced global economy. In that regard, U.S. monetary authorities have emphasized that dollar depreciation was not an objective of recent policy actions, but it was one of several channels through which those actions work to strengthen the U.S. economy. A stronger U.S. economy, it is argued, is in the interest of the global economy. Given the paralysis in fiscal policy, the scope for alternative macroeconomic policies to accomplish that objective is limited, and a critical virtue of a flexible exchange rate system is the autonomy it gives to each monetary authority to pursue the best interests of its home economy, taking account of feedbacks and interactions with other economies.

A second issue is the two-speed economic expansion, with many key industrial economies weak and emerging market economies much stronger. In that context, the reliance on monetary policy to boost growth means that the pressures on EME markets arise from many sources, not just the United States, and are not likely to abate soon.

The very limited flexibility in some currencies, especially that of China and those other countries whose economies are heavily influenced by competitive relationships with China is exacerbating the pressures on EME asset prices and inflation. It inhibits the ability of the monetary authorities to tighten policy to contain inflation pressures. And it encourages capital inflows because investors see not only higher nominal returns from sending capital to these economies but also a one-way bet on the currency.

Moreover, the lack of flexibility in exchange rates is also constraining the global rebalancing required as economies return to higher levels of output and employment. Global imbalances did not directly cause the crisis as many had feared, and certainly many banking crises have started in countries, like Japan, that were running current account surpluses. But the imbalances contributed to the conditions that encouraged the build up of debt and leverage in the United States. Surpluses in EMEs recycled into the U.S. financial markets as net official capital inflows held down intermediate and long-term interest rates adding to the run up in house prices; the build up in debt that corresponded to the current account surplus and the U.S. consuming more than it produced came to rest in the household and government sectors; and the demand for high-quality assets from abroad helped to induce the U.S. financial sector to invent new forms of AAA-rated assets that proved vulnerable to systematic risk.

The recovery of the global economy cannot rest on the U.S. consumer or on demand by governments in industrial countries. Financial and economic stability require a higher level of domestic saving in the United States by households and governments. By the same token, other economies cannot rely on exports to U.S. and other industrial countries as the main driver of demand. Instead more global demand must come from increased domestic purchases by those economies currently in large and growing surplus positions, especially where those balances reflect not persistent fundamentals of productivity and thrift but rather artificial controls on exchange rates or capital flows and inadequately developed safety nets and financial systems. Policies to shift demand through incentives in government taxes and spending and regulation must play a role in realigning global demand and production. But relative prices will also have to change and the less painful way to do that is through movements in exchange rates rather than through inflation in surplus countries and deflation in deficit countries.

The Alignment of U.S. and European Interests

The events of the past few years have demonstrated all too vividly the shared interest in strong stable economies and financial markets in both locales. They are important trading partners and markets for each other's exports, and with financial institutions operating freely across borders, shocks or concerns about performance in one area are instantaneously transmitted to the other.

Efforts in either jurisdiction by the fiscal authorities to establish sustainable debt paths and by the monetary authorities to achieve inflation objectives, if successful, will ultimately benefit both jurisdictions. To be sure, some policies, like fiscal consolidation in Europe and monetary expansion in the US, may have short-run adverse spillover effects on the exports of the other area, and those policies should take account of these spillovers and feedbacks. But the appropriate response in the affected jurisdiction is to support stabilizing policies and to adjust its own policies if necessary in light of its knowledge of and consultation with the other jurisdiction. Market-determined exchange rates make such adjustments possible.

Although the United States and Europe are in different current account positions, they also have a shared interest in more balanced growth globally and the additional exchange rate flexibility that would make that possible. As noted, although unbalanced growth wasn't the primary cause of the financial crisis, it was a contributor. Greater domestic demand from the EMEs, where policies should be less constrained than are fiscal and monetary policies in the U.S. and Europe, would help both areas pull out of the slump more quickly with less lasting damage. To accommodate greater domestic demand without inflation and to focus some of that demand to the industrial economies relative prices of tradables and nontradables must change. The change in relative prices will be more readily accomplished through exchange rate flexibility.

Greater exchange rate flexibility and more balanced growth would help to promote the free flow of capital and goods and services globally to the benefit of both economic areas. Both Europe and the United States must resist the protectionist pressures that could well intensify as the recoveries in both areas proceed slowly. That will be easier in the United States when production in export and import competing industries as well as in investment goods picks up some of the slack left by consumption goods and residential investment. Where emerging economies are concerned about inflows of capital and inflation, greater exchange rate flexibility should help to damp inflows an contain inflation. Both Europe and the United States should encourage these countries to focus macroprudential policies on domestic institutions and to keep capital taxes and controls small, temporary and targeted, so as to interfere as little as possible with the long-run allocation of capital.