Economic Growth and Job Creation: The Road Forward

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Chairman Bachus, Ranking Member Frank, other members of the House Committee on Financial Services, thank you for the opportunity to testify at this important time on monetary and fiscal policies to promote economic growth and job creation.

After more than three years since the financial crisis flared up and the recession began, the unemployment rate is still over 9 percent, and has been over 9 percent for 20 consecutive months. Individual durations of unemployment have gotten so long that this month the Bureau of Labor Statistics lengthened the maximum unemployment duration in its monthly survey from two years to five years. As I testified[1] last year, my empirical research shows that discretionary government interventions in the monetary, fiscal, and regulatory policy areas are unfortunately largely responsible for much of the crisis and lower economic growth which has led to the high unemployment. The clear implication of this research is that a reform of policy is the key to sustained economic growth and reduced unemployment going forward. In this testimony I focus on fiscal and monetary policy reforms.[2]

Many discretionary interventions were taken before or during the panic in the fall of 2008, but in the past two years policy makers have doubled down on the interventions. On the fiscal side we have seen an $862 billion stimulus package, an increase in annual federal spending from 21 to 25 percent of GDP, and a corresponding explosion of federal debt. On the monetary side we have seen Quantitative Easing 1 (QE1) of $1.55 trillion, Quantitative Easing 2 (QE2) of $600 billion, and a corresponding explosion of the Federal Reserve's balance sheet. On the regulatory side we have seen thousands of pages of legislation with new regulations in the health and financial sectors.

When you look at each of the monetary and fiscal interventions during the past two years you see that they had little effect in stimulating the economy or reducing unemployment. The one-time stimulus payments to people did not jump-start aggregate consumption. The federal stimulus funds sent to the states did not increase infrastructure spending. The cash for clunkers

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[1] "An Exit Rule for Monetary Policy," Testimony before the Committee on Financial Services, U.S. House of Representatives, March 25, 2010; "Perspectives on the U.S. Economy: Fiscal Policy Issues," Testimony before the Committee on the Budget, U.S. House of Representatives, June 30, 2010; "Assessing the Federal Policy Response to the Economic Crisis," Testimony before the Committee on the Budget. U. S. Senate, September 22, 2010.

[2] Other important policy reforms in the financial area include Fannie Mae, Freddie Mac, and the bankruptcy code for large financial firms (Chapter 11F).

program merely shifted consumption a few months forward in time. The purchase of mortgage backed securities under QE1 did not have a material impact on mortgage interest rates once other risks are taken into account. At best these actions had a small temporary effect which dissipated quickly with no lasting boost to economic growth or job creation. Moreover, the increased debt, monetary overhang, and uncertainty about new regulations have likely been a drag on the economy.

None of this should be surprising. Well-known economic theories of consumption—such as the permanent income or life cycle theory—predict that temporary payments to households will not increase consumption by much. Careful empirical studies of fiscal stimulus programs in the late 1970s showed that sending stimulus grants to the states did not increase infrastructure spending. A vast literature and experience from the 1970s shows that discretionary monetary policy, as distinct from more rules-based policy, leads to boom-bust cycles with ultimately higher unemployment and higher inflation. In contrast when sounder, more stable and more predictable monetary and fiscal policies were followed in the 1980s and 1990s we had higher economic growth and lower unemployment.

In sum, basic economic principles and practical experience—including the painful experience of the past few years—point clearly to the best road forward to promote economic recovery and job creation: *restore sound fiscal policy and sound monetary policy*.

Historical research shows that the policy pendulum swings back and forth over time. The discretionary monetary and fiscal policies which brought on double digit unemployment, interest rates and inflation in the 1970s, gave way to sounder monetary policy and less interventionist fiscal policy in the 1980s and 1990s and economic performance improved. So too the recent discretionary policies which led to poor economic performance may be giving way to sounder policies and thereby improved economic growth and job creation.

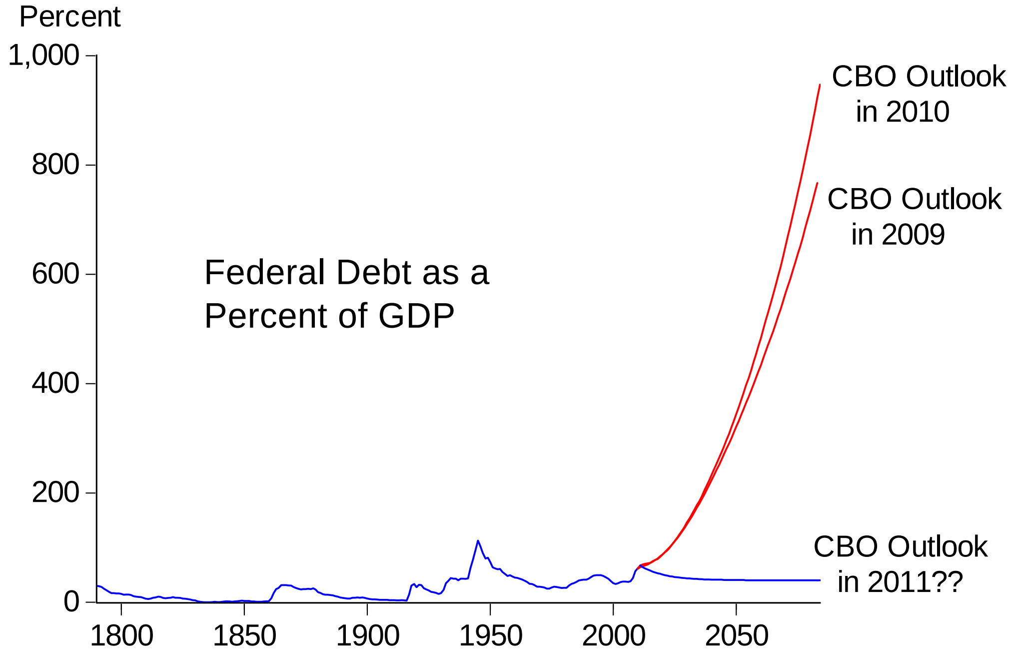
Indeed, there are welcome signs that the policy pendulum has begun to swing back to sound policies. Opinion polls reveal great concern about the higher debt, deficits, and government spending; the recent election brought the same message from the electorate. Three-fourths of business economists and one-half of academic economists in a recent poll now say that overly easy monetary policy exacerbated the housing boom and thus the bust which led to the financial crisis. Reactions to QE2 have been quite negative at home and abroad. The very word "stimulus" is now avoided by former proponents of the stimulus packages. The recent agreement to extend existing income tax rates across the board—and the expectations that the agreement will eventually extend beyond two years—provides additional evidence of an actual shift to more predictable and less uncertain policies. We can hope that the mantra "temporary, targeted, and timely" will be replaced with "permanent, pervasive, and predictable."

But it is essential for policymakers to grab the pendulum, pull it back toward sound policy, and tie it in place before it swings back again.

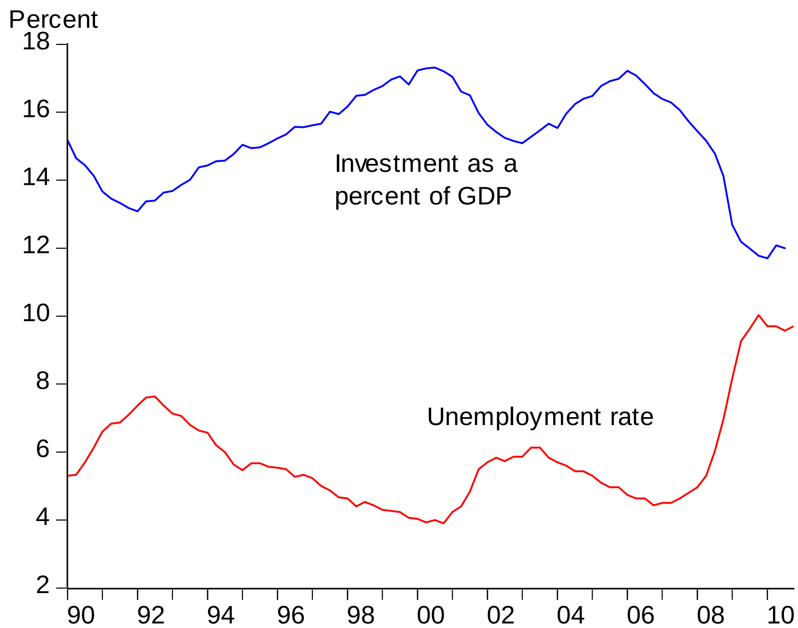
Toward a Sound Fiscal Policy

In the area of fiscal policy it is important to lay out a credible long term plan to reduce spending and stop the exploding debt. The plan should start immediately by bringing fiscal year 2011 levels of discretionary spending to 2008 levels; if spending can then be further brought toward 2000 levels as a share of GDP and held there with entitlement reforms, then the budget can be balanced without growth-retarding tax rate increases.

A concrete goal should be to lay out a credible budget reform plan which the Congressional Budget Office (CBO) can credibly score as reversing the debt explosion they projected last summer. Making the plan ready in time for the CBO's long term projections of next summer will give a good boost to economic growth and job creation as uncertainty about the future sustainability of the debt is reduced. An example of what next summer's CBO's projections might look like in comparison with the past two summers is shown in the following graph of the federal debt as a percentage of GDP.



Some say we need to wait to start reducing government purchases because of the high unemployment and the fragile recovery. Some even say we need to increase spending before we start reducing it. But there is no convincing evidence that a gradual and credible reduction in government purchases as a share of GDP will increase unemployment. Indeed, the history of the past two decades shows that lower levels of government purchases as a share of GDP are associated with lower unemployment rates. The same history suggests that the surest way to reduce unemployment is to increase private investment as a share of GDP: Over the past two decades, when investment increased as a share of GDP, unemployment fell. In other words, unemployment is inversely correlated with private investment, as the chart below shows. So reducing the share of government spending and focusing on increasing the share of private spending—at least over the ranges shown in the chart—is a proven way to create jobs and reduce unemployment.



Toward a Sound Monetary Policy

Just as the Congress and the President should lay out a plan for reducing the debt, the Federal Reserve should lay out an exit strategy for reducing the size of the its unusually large balance sheet. The exit strategy would be put into action when the time comes to begin raising interest rates, but specifying it now would reduce uncertainty.[3]

The exit should be to a more rules-based monetary policy of the kind characteristic of the 1980s and 1990s. QE1 and QE2 are part of the trend toward more discretionary and less rules-based monetary policy, which started with decisions to hold interest rates very low in 2003-2005. While the Federal Reserve deserves credit for helping to stop the panic in the fall of 2008, on balance, the discretionary actions have been harmful. Moreover, QE1 and the bailout of the creditors of several financial firms immersed the Fed into fiscal policy, including credit allocation and risk-taking, which circumvent the normal appropriations process. The Fed should be independent to make monetary policy decisions, but many Americans rightly question this independence when the Fed engages in fiscal policy.

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[3] An example of such an exit strategy was proposed in my testimony "An Exit Rule for Monetary Policy," before the Committee on Financial Services, U.S. House of Representatives, March 25, 2010

Clarify the Objectives

In order to achieve a more predictable rules-based policy and bolster the Fed's independence in the monetary policy area, Section 2 of the Federal Reserve Act, which lays out objectives and reporting requirements for the Fed, should be amended. Section 2A calls for the Fed to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." It would be better for economic growth and job creation, if the Fed focused on the goal of "long run price stability within a clear framework of economic stability." Such a reform would not prevent the Fed from providing liquidity, serving as lender of last resort, and cutting the interest rate in a financial crisis or a recession; through the language "within a framework of economic stability" the legislation would make this clear.

Such a clear price stability goal would provide a foundation for strong employment growth. Too many goals blur responsibility and accountability for any organization, and they allow for changing the emphasis on one goal versus others over time. Recently the multiple objectives in Section 2A have been cited as a rationale for unconventional interventionist policies, such as QE2, an approach which was avoided during the 1980s and 1990s. But such interventions often have the unintended consequence of leading to higher unemployment as illustrated by the decisions to hold interest rates very low in 2003-2005 which may be responsible for the high unemployment rates in the United States today.

Restore Reporting and Accountability Requirements

Section 2B of the Federal Reserve Act should also be changed. During the 1980s and 1990s, the Federal Reserve Act required that the Fed report its ranges for the growth rates of the "money and credit aggregates" in writing and in public hearings before Congress. If the Fed deviated from those ranges, the Fed was required to be accountable by explaining the reason for the deviations, again in writing and in public hearings before Congress. However, these specific reporting and accountability requirements were removed from the Federal Reserve Act in 2000. They should be restored, but with some changes that reflect recent practical experience.

Rather than focusing on the monetary aggregates, they should require the Fed to report on the strategy (or rule) that the Fed plans to use for setting interest rates in order to achieve the goal of price stability. The Fed should establish and report its own strategy and not have one dictated by Congress. The strategy should be as simple as possible without being too simple and it should include a description of the quantitative responses of the interest rate to developments in the economy.

In addition to choosing its own strategy, the Fed should have the discretion to deviate from its strategy in a crisis or other unanticipated change in circumstances. However, if it does deviate it must report in writing and in public hearings the reasons for such deviations. This requirement provides a degree of accountability needed for an independent agency of government.

This approach would provide a degree of control of monetary policy by the American people through their representatives without interfering in day-to-day operations of policy. It would help restore the independence of the Fed by taking political pressure out of the day-to-day decisions. Such a reform will reverse the short-term focus of policy and restore credibility in sound monetary principles and help achieve strong economic growth and job creation now and in the years ahead.

Conclusion

In this testimony I have argued that proven economic principles and practical policy experience show that the best road forward to strengthen economic growth and create jobs is through sound fiscal policy and sound monetary policy. I have also given some recommendations of how to restore sound fiscal policy and sound monetary policy. While there are signs that the pendulum is already beginning to swing back toward such policies, bold legislative actions will be required to achieve them.

I thank you for the opportunity to testify, and I would be happy to answer any questions you may have.