

## Keynesian excess: Easy policy and slower economic growth

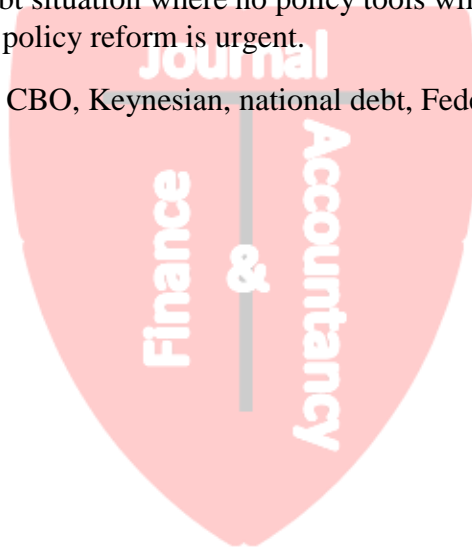
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### ABSTRACT

Since the recession of 2007-2009, US fiscal and monetary policies have been drastic and unprecedented. Huge annual budget deficits have added \$10 trillion to the national debt. This pressure from fiscal policy has forced the Federal Reserve to create excess reserves to boost its balance sheet from \$800 billion to \$3.2 trillion. The Congressional Budget Office projects that the public debt could reach 200% of GDP by 2040. These drastic policy measures are leading the US to an unsustainable debt situation where no policy tools will be available to correct the problems. The need for fiscal policy reform is urgent.

Keywords: economic growth, CBO, Keynesian, national debt, Federal Reserve



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## INTRODUCTION

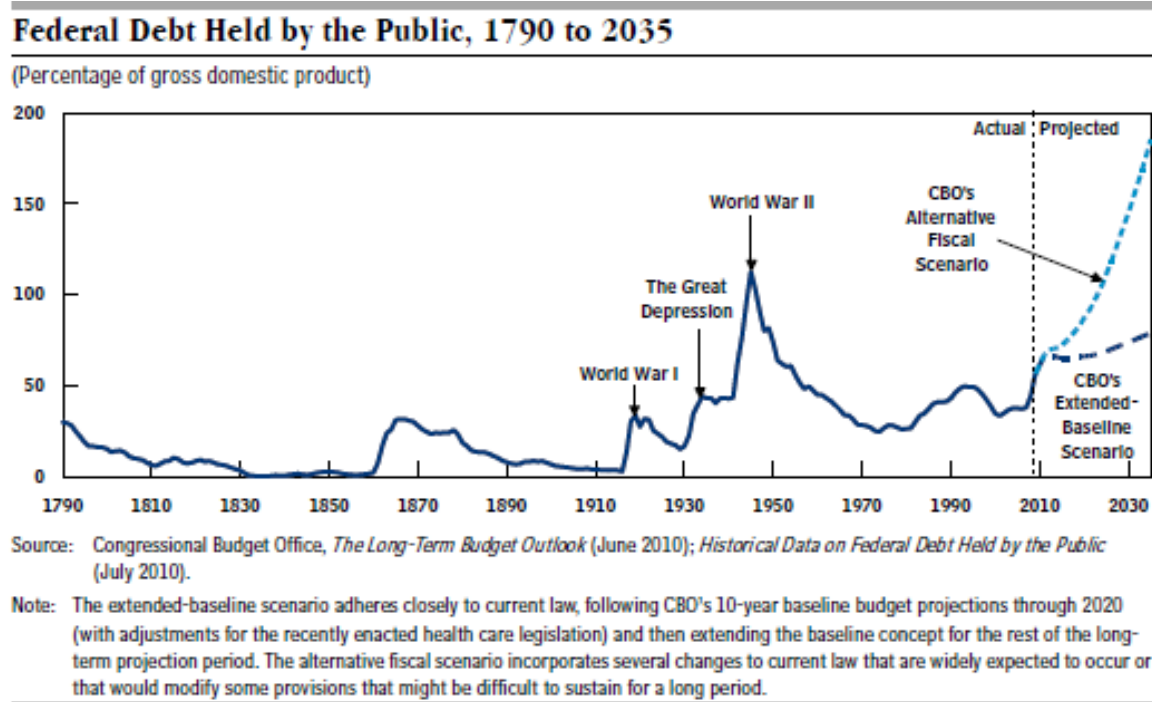
The Great Recession of 2007-2009 was deep and severe. It was precipitated by a sub-prime mortgage crisis that had been building for several years. Reduced mortgage standards initiated by Fannie Mae and the very low interest rates (1%) initiated by the Federal Reserve in 2001-2004 combined to create the perfect storm. Following the recession of 2001, there was a boom in home buying, and house prices in some markets rose as much as 20% per year during 2003-2007. Speculation in condos by investors was rampant. By 2007 many sub-prime mortgages had been embedded in mortgage backed securities (MBS) owned by financial institutions around the world, which saw US mortgage loans as a safe investment. Concurrently during the same period a large market in credit default swaps (CDS) developed. Insurance companies would guarantee certain financial instruments against default for a fee, however there were no loss reserves set aside for the risk in this unregulated market.

By mid-2006 the Federal Reserve had increased short term interest rates to 5.25%, causing many adjustable rate mortgages to adjust payments upward, and the housing boom cooled. Mortgage delinquency rates started to rise, and then foreclosures started to rise. MBS owners began to sell their investments, and by the fall of 2008 MBS prices plummeted quickly. This sharp decline in MBS prices, coupled with GAAP accounting rules, forced some large financial institutions to mark their MBS to market value, imposing huge losses.

Suddenly in 2008 the rising interest rates had triggered large losses of market value among the players in the MBS and the CDS markets. Lehman Brothers and Bear Sterns failed. Bank of America was “encouraged” to buy Merrill Lynch and Countrywide Funding. Shortly thereafter J. P. Morgan bought Chase Bank. Goldman Sachs and others became bank holding companies to gain access to the Federal Reserve Discount Window. AIG, the largest insurance firm in the world, was bailed out and acquired by the US government. Within five days Congress approved a \$787 billion fund for “troubled asset relief”. The US government took over Fannie Mae and Freddie Mac, the two privately owned “government sponsored enterprises” in the housing market. The recession also pushed General Motors and Chrysler into default and later bankruptcy, with government bailouts in 2008.

These measures in 2008 were extraordinary, but they worked well to stabilize the financial system. By late 2009 the recession ended, however the recovery since then has been extremely slow by post war standards. In the four years since the recession, federal government budgets have increased sharply. The deficits have brought the national debt in the hands of the public to 73% of GDP at the end of 2012, up from 36% of GDP in 2007. This doubling of the debt-to-GDP ratio poses dangers for the economy, and it is unknown if policymakers have the tools and the will to resolve the problem. (See Congressional Budget Office, 2013). In dollar terms, the public debt increased from \$5.8 trillion at the end of 2008 to \$11.3 trillion at the end of 2012. Figure 1 shows the CBO projection that, under current policy, the public debt will approach 200% of GDP by 2040.

Figure 1



## THE POLICY MIX

Both fiscal and monetary policy measures have been used to deal with these important issues. Congress passed significant stimulus spending to promote jobs, extended unemployment compensation to 99 weeks, rescued the auto manufacturers, bailed out the mortgage GSEs, and promoted green energy. The Federal Reserve adopted seven “lending facilities” and significant “quantitative easing” in four phases to stabilize the financial system and promote job creation. Table 1 shows the specific CBO projections under the most likely “alternative fiscal scenario.”

The result thus far has been the slowest economic recovery on record. In only one quarter since the recession has real GDP grown at an annual rate above 4%. In the four years after the last recession, real GDP growth has averaged a 2% annual growth rate, compared to 5% after the 1981 recession and 3.2% after the 1991 recession. The weakness in the current cycle also is seen in the labor market. After peaking near 10%, the unemployment rate (unemployed/labor force) remains at 7.6%. The more important employment rate (employed/population) has remained flat at 58.5% for the past four years. In contrast to previous business cycles, many people have left the labor force. Long term unemployment has increased to 45% of the unemployed, much higher than the peak of 27% after the severe 1981 recession. (See Lazear, 2013).

The Federal Reserve has adopted unprecedented measures to deal with the financial crisis and promote economic growth. To deal with the freezing of lending markets in 2008, the Federal Reserve created lending facilities so not only banks but also other key institutions, such as commercial paper dealers, could gain access to the Discount Window. This effort provided essential liquidity to the markets, and these facilities have now been closed. The Federal Reserve also embarked on “quantitative easing” measures which involved buying US government bonds in the open market to funnel cash reserves into the banking system. This

effort was expanded to include the purchase of MBS as well. Currently the Federal Reserve is buying \$85 billion each month in Treasury securities and MBS, and has announced this program will continue indefinitely until the unemployment rate drops to 6.5%. The unemployment rate has been dropping, but very slowly. It appears that monetary policy alone may not be sufficient to spur job creation in the midst of huge budget deficits, potential tax increases, added government regulation, and budget sequestration. Fiscal policy also has delivered unprecedented measures that may be adversely affecting private sector spending, investment, and hiring. The large budget deficits of 2008-2013 exceeded \$9 trillion. The 2008 takeover of the automobile manufacturers also were unprecedented. The subsequent General Motors bankruptcy was resolved in an unconventional way that protected the labor union pension fund at the expense of bondholders with a higher priority in bankruptcy policy. It appears that standards for awarding Social Security Disability pensions have been relaxed. Disability rolls have increased 13% since 2009 to about 11 million. The number of people receiving food stamps has increased 39% since 2009 to about 45 million. Many federal benefits designed to assist low income and disabled people are designed to phase out as income rises.



Table 1

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Total		
												2013-	2013-	
	In Billions of Dollars													
<i>CBO's January 2012 Baseline</i>														
Revenues	2,523	2,988	3,313	3,568	3,784	4,039	4,243	4,456	4,680	4,926	5,181	17,692	41,179	
Outlays	3,601	3,573	3,658	3,836	4,086	4,259	4,439	4,714	4,960	5,205	5,520	19,413	44,251	
<b>Deficit</b>	<b>-1,079</b>	<b>-585</b>	<b>-345</b>	<b>-269</b>	<b>-302</b>	<b>-220</b>	<b>-196</b>	<b>-258</b>	<b>-280</b>	<b>-279</b>	<b>-339</b>	<b>-1,721</b>	<b>-3,072</b>	
Debt Held by the Public at the End of the Year	11,242	11,945	12,401	12,783	13,188	13,509	13,801	14,148	14,512	14,872	15,291	n.a.	n.a.	
<i>Alternative Fiscal Scenario</i>														
Revenues	2,500	2,680	2,904	3,126	3,324	3,556	3,732	3,915	4,100	4,305	4,513	15,589	36,154	
Outlays	3,611	3,661	3,820	4,024	4,305	4,516	4,738	5,059	5,353	5,649	6,008	20,328	47,136	
<b>Deficit</b>	<b>-1,111</b>	<b>-981</b>	<b>-917</b>	<b>-899</b>	<b>-981</b>	<b>-960</b>	<b>-1,005</b>	<b>-1,144</b>	<b>-1,253</b>	<b>-1,344</b>	<b>-1,495</b>	<b>-4,739</b>	<b>-10,981</b>	
Debt Held by the Public at the End of the Year	11,275	12,374	13,402	14,414	15,499	16,560	17,661	18,895	20,232	21,657	23,232	n.a.	n.a.	
<b>As a Percentage of Gross Domestic Product</b>														
<i>CBO's January 2012 Baseline</i>														
Revenues	16.3	18.8	20.0	20.2	20.2	20.5	20.5	20.6	20.7	20.9	21.0	20.0	20.4	
Outlays	23.2	22.5	22.1	21.8	21.8	21.6	21.5	21.8	21.9	22.0	22.4	21.9	21.9	
<b>Deficit</b>	<b>-7.0</b>	<b>-3.7</b>	<b>-2.1</b>	<b>-1.5</b>	<b>-1.6</b>	<b>-1.1</b>	<b>-0.9</b>	<b>-1.2</b>	<b>-1.2</b>	<b>-1.2</b>	<b>-1.4</b>	<b>-1.9</b>	<b>-1.5</b>	
Debt Held by the Public at the End of the Year	72.5	75.1	74.8	72.6	70.5	68.5	66.8	65.5	64.2	63.0	62.0	n.a.	n.a.	
<i>Alternative Fiscal Scenario</i>														
Revenues	16.1	16.8	17.5	17.7	17.8	18.0	18.1	18.1	18.1	18.2	18.3	17.6	17.9	
Outlays	23.3	23.0	23.0	22.8	23.0	22.9	22.9	23.4	23.7	23.9	24.4	23.0	23.4	
<b>Deficit</b>	<b>-7.2</b>	<b>-6.2</b>	<b>-5.5</b>	<b>-5.1</b>	<b>-5.2</b>	<b>-4.9</b>	<b>-4.9</b>	<b>-5.3</b>	<b>-5.5</b>	<b>-5.7</b>	<b>-6.1</b>	<b>-5.4</b>	<b>-5.4</b>	
Debt Held by the Public at the End of the Year	72.7	77.8	80.9	81.8	82.9	84.0	85.5	87.4	89.5	91.7	94.2	n.a.	n.a.	
<b>Memorandum:</b>														
Deficit: Alternative Fiscal Scenario														
Minus CBO's January 2012 Baseline														
In billions of dollars	-33	-396	-572	-630	-679	-740	-810	-886	-973	-1,065	-1,156	-3,018	-7,909	
As a percentage of GDP	-0.2	-2.5	-3.5	-3.6	-3.6	-3.8	-3.9	-4.1	-4.3	-4.5	-4.7	-3.4	-3.9	
Policy Alternatives That Affect the Tax Code														
(Billions of dollars)														
Effect on revenues	-23	-309	-410	-442	-460	-483	-511	-541	-579	-621	-668	-2,104	-5,024	
Effect on outlays	0	1	39	41	42	43	43	43	42	42	42	166	378	
Effect on the deficit <sup>a</sup>	-23	-309	-449	-483	-502	-526	-554	-584	-622	-663	-710	-2,270	-5,403	

Source: Congressional Budget Office.

Notes: The alternative fiscal scenario incorporates the assumptions that all expiring tax provisions (other than the payroll tax reduction), including those that expired at the end of December 2011, are instead extended; that the alternative minimum tax is indexed for inflation after 2011 (starting at the 2011 exemption amount); that Medicare's payment rates for physicians' services are held constant at their current level; and that the automatic enforcement procedures specified by the Budget Control Act of 2011 do not take effect. Outlays under the alternative fiscal scenario also include the incremental interest costs associated with projected additional borrowing.

GDP = gross domestic product; n.a. = not applicable.

a. Negative numbers indicate an increase in the deficit.

It may be that these programs are having the consequence of encouraging at least some people to stay unemployed or out of the labor force to preserve their benefits. Also, passage of the Affordable Care Act in 2010 may have inspired some who see government benefits as an alternative to working. Each of these costly programs adds to federal spending and the budget

deficit. Strong political support for these programs makes it difficult to reach agreements in Congress on how to reconcile budget outlays and tax revenues.

### **FAILED ATTEMPTS AT FISCAL BALANCE**

In 2010 the President created the National Commission on Fiscal Responsibility and Reform, chaired by Alan Simpson and Erskine Bowles. This Simpson-Bowles Commission was charged with the task of recommending to Congress a plan for achieving fiscal balance through tax reform and spending reform. The final report of the Commission used both tax cuts and spending reform to eliminate the federal budget deficit by 2035. The Executive Order establishing the Commission called for a favorable vote by 14 of the 18 members to send the plan to Congress for a vote. The report failed when only 11 members voted for it. Although the Simpson-Bowles blueprint for fiscal reform did not achieve its purpose in 2010, some political leaders believe it is still a good basis for a budget agreement.

Since 2010, Congress has failed to reach agreement on fiscal reform. With the debt ceiling looming in 2012, Congress set another goal of reaching a fiscal compromise. The built-in incentive to agree was a planned sequester of both defense and non-defense spending in 2013. That effort failed, and the sequester of spending started in 2013. It still remains unclear how or when political leaders will deal with the issue of fiscal balance.

### **MONETARY POLICY ATTEMPTS TO BOOST THE ECONOMY**

Since 2008 the Federal Reserve has maintained an aggressive monetary policy. Not only have short term interest rates been held very low (near 0.25%), but innovative policies have been adopted to reduce intermediate term rates as well. "Operation Twist" involved buying intermediate term notes and selling short term bills to flatten the yield curve. In addition the Federal Reserve adopted unprecedented efforts to buy more bonds and MBS as a form of "quantitative easing". Currently the Federal Reserve is buying \$85 billion per month on these instruments, and it plans to do so until the unemployment rate falls to 6.5%.

The impact of this monetary policy is to hold yields on Treasury bills barely above zero. The yield on ten year Treasury bonds is near 2%. Banks have benefitted from this policy because their cost of funds is low, widening the spread vs. their portfolio yield. Savers and potential retirees have suffered because the investment yield they achieve is very low. As a result many investors have been pushed to seek higher yields in the stock market. Over the past two years the major market indexes have increased more than 60%. Some market analysts fear a bubble is forming in stocks, which could lead to a sharp falloff in market values. A similar situation arose when the sudden end of the internet bubble was followed by a stock market selloff in March 2001. If the Federal Reserve were to quickly curtail its purchases of bonds, bond prices would fall and yields would rise, threatening the macro economy. The Federal Reserve acknowledges this risk, and they assure the markets that policy changes will be gradual. Since 2008 the Federal Reserve balance sheet has been expanded to unprecedented levels from \$800 billion to \$3 trillion by this QE program, and no one knows what the result will be.

Another concern is that the Federal Reserve is buying most of the new issues of Treasury debt. This action keeps interest rates low and facilitates the large budget deficits of the federal government. Currently the annual interest on the national debt is about \$1.4 trillion. However, if interest rates rose to a more normal 4%, the federal interest expense would increase sharply, as there is little hope of paying down the balance anytime soon. Such an added expense would

require some combination of tax increases, spending cuts, or more borrowing to avoid larger deficits. Each of these poses a threat to economic growth and prosperity.

## **DEBT THREAT**

The debate continues in policy circles as to the effects of a large national debt. Some fear that a large national debt would tend to increase the interest rates at which a nation could borrow, making it even more difficult to finance deficits. They point to the recent troubles in Greece and Spain as examples of high debt leading to higher financing costs, and another round of higher debt. In their recent book This Time is Different, Reinhart and Rogoff report a study of 800 financial crises over the past 1,000 years. They suggest once a national debt exceeds 90% of GDP a financial crisis is much more likely. The US public debt to GDP ratio is near 76%, and under the CBO Baseline Scenario is set to reach 200% by 2035. (CBO, 2013; Reinhart, 2009)

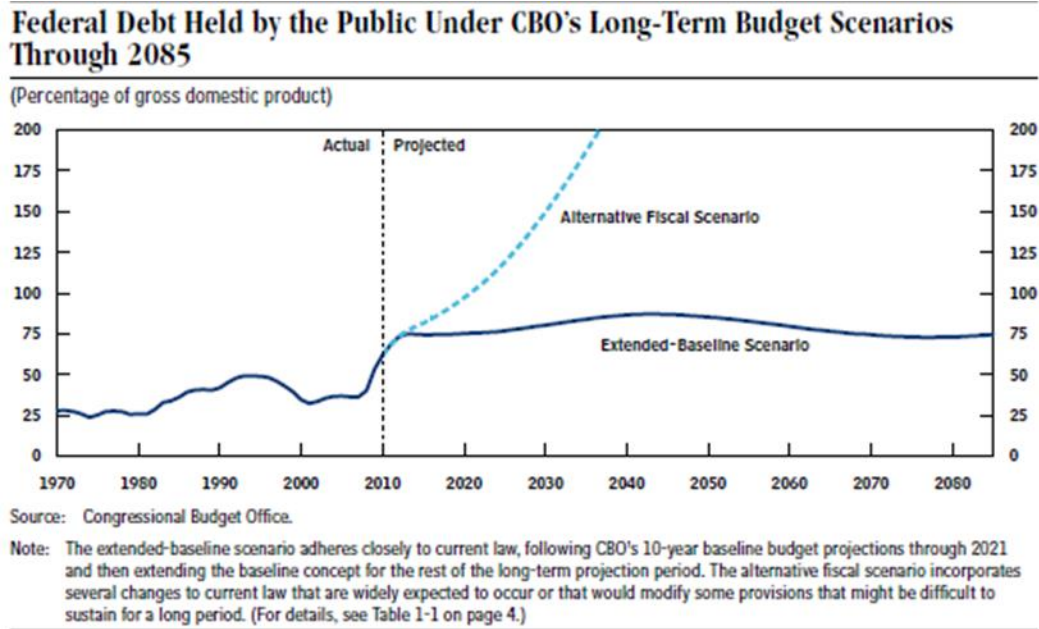
While these concerns are significant, there are additional aspects of the financial obligations of the federal government. The public debt does not include other potential obligations. For example the Social Security System is projected to exhaust its trust funds in 2036. Medicaid is in a similar condition. Fannie Mae and Freddie Mac continue to be wards of the federal government, although they have earned a profit recently. The US Postal Service has significant shortfalls in revenues, as does AMTRAC. Many state and local governments have severely underfunded pension liabilities, and many are still assuming annual portfolio yields of 8% to support their obligations. On the international scene, a two-year war rages in Syria, Iran and North Korea are becoming nuclear weapon threats, and stability of the Eurozone is uncertain. Each of these represents a risk to the fiscal balance of the US.

## **CONCLUSIONS AND RECOMMENDATIONS**

The state of US economic policy is in disarray. The highly charged political atmosphere of the past few years has tied the hands of Congress in executing fiscal policy. The burden of action has fallen to monetary policy. Although the huge budget deficits have been a stimulus in the Keynesian sense, the associated debt may well be limiting economic recovery and growth, in the Rational Expectations sense. Federal policy on environmental issues and financial regulation also may be limiting economic recovery and growth. In addition to the national debt held by the public, the federal government has many other official and implied obligations, just at a time when the Baby Boom generation is nearing retirement age, and a massive overhaul of the healthcare system is being implemented.

It is essential to move quickly toward a resolution of these severe fiscal problems. Failure to do so will lead to the financial crisis illustrated by Figure 2. The Simpson-Bowles framework for compromise would be an excellent starting point. Political leaders must work together to resolve these issues which are delaying economic recovery and growth. Without timely change, many other important goals cannot be achieved.

Figure 2



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