A report on the US Economy

Bruegel Lunchtalk, 25/03/2011

On the 25th of March, Bruegel hosted **Richard Fisher,** President and CEO of the Federal Reserve Bank of Dallas and **Bruce Stokes,** Senior Transatlantic Fellow at the German Marshall Fund, for a lunchtime discussion on the State of the US Economy. Speaking in his personal capacity, **Richard Fisher** provided his views on the state of the US economy with **Bruce Stokes** providing elements of political context. **Jean Pisani-Ferry**, Director of Bruegel, chaired the discussion.

Richard Fisher began by reminding the audience of the extraordinary measures put in 2008 and 2009, when markets ground to a halt, confidence evaporated and the Federal Reserve decided to "*step into the breach and put trillions of dollars at risk".* The actions taken proved decisive, and almost all of the programs were subsequently unwound. But this, **Richard Fisher** highlighted, was all done at great cost: at the cost of maintaining the Federal Reserve's reputation for independence, and at great costs for those who had "*played by the rules, and saved their money properly*" and now have to accept low rates of return on their savings.

Even through the measures we appropriate at the time, **Richard Fisher** argued that the situation had changed and was now one of excess liquidity. Surveys and market indicators indicate that "*no one is complaining about not having access to capital, and no one is complaining about the cost of capital".* The overabundance of liquidity is encouraging the type of behaviour seen before the crisis, and leverage is extending even to those investors that were traditionally unleveraged, he stated. The current stock market rally is also of historical magnitude. All the evidence seems to show that liquidity is no longer the US economy's main problem and that the central bank has "*done enough*", perhaps even overdone its job.

Richard Fisher strongly emphasised the need to preserve the Federal Reserve's independence, especially as the latest round of so-called "quantitative easing" could be construed as an outright monetization of the debt between November 2010 and June 2011. It needs to be made clear that the central bank is "*not the instrument of the fiscal authorities in the United States, or other political authorities",* he said. Fiscal irresponsibility should not be accommodated any further by monetary policy, at the risk of increasing even more the debt burden facing future generations. He admonished the US fiscal authorities to "*get their house in order*" and urgently wean themselves off an addiction to debt and spending, and to cease looking towards monetary policy. History has shown what happens, **Richard Fisher** said, when political judgements override economic judgements in central banking.

Bruce Stokes then took the floor, and began by stating that the US public was sending very mixed messages on the set of issues discussed by **Richard Fisher.** Concerns recently seemed to be shifting away from jobs and towards the deficit and inflation, although this shift is not yet visible throughout the political spectrum. The pressure to focus on jobs, he explained, is due to the severity of the employment recession: every job created since Regan's first term has been destroyed. However, 55% of Americans seem to say that cutting the deficit should be the government's priority

– but without raising taxes (66%) or touching Medicare and Social Security (65% and 61% respectively). "*How you get from here to there without some revenue enhancement",* and without touching some of the largest spending programs, "*isn't clear to me"*, he stated.

Moreover, the public seems to have little faith in either party to deal with the budget challenges. **Bruce Stokes** indicated that only a fifth of the public had faith in the President to tackle the issue, and only a fifth had faith in the Republican leadership in Congress to deal with it. The drop in support for the Republican leadership - usually the most vocal about budgetary problems - has been particularly sharp, especially among "Tea Party" independents. **Bruce Stokes** said that although they were critical in bringing the issue to the forefront of debates, "Tea Party" advocates have indicated by 2 to 1 that elected representatives should stick to principles, rather than compromise. In the end, all of these observations highlight how difficult it will be to reach an agreement on budget consolidation. The US appears "*not quite ready"* and perhaps will not be until the next election.

Drawing on the discussion, **Jean Pisani-Ferry** provided elements of comparison with Europe. In the very recent past, the budgetary stance has been very different on both sides of the Atlantic. Prior to the crisis the fiscal situations were "*roughly the same*", yet adjustment has already started taking place in Europe whereas there is clearly no appetite for it in the United States at this time. Moreover, the effects of the deleveraging cycle in the United States will in all likelihood be greater than in the Euro Area and raises the crucial question of where private demand will come from in the medium-term. The other striking difference is in terms of the response of unemployment: the United States experienced an extraordinary productivity surge, whereas in Europe productivity is essentially at pre-crisis levels.

In trying to understand divergences in terms of policy response, **Jean Pisani-Ferry** stated that it was crucial to untangle what was due to differing situations, what was due to different beliefs, and what could be explained by political economy constraints. He explained that the different policy responses we have been seeing over the past year can, in part, be explained by diverging assumptions on the future. In the UK and in Europe, authorities have revised structural unemployment upward and potential output downward quite sharply. In the United States, official forecasts have been much less pessimistic. All of the policy discussion in Europe, he said, *"is based on the assumption that there is a permanent loss, and that we cannot just grow out of the problem; it has to take place, essentially, through adjustment".* To the extent that structural unemployment in the US is not affected, the productivity surge can be construed as supporting this view. But **Jean Pisani-Ferry** highlighted that something seemed to be changing in the historical relationship between vacancies and unemployment in the United States (the so-called "Beveridge curve"), leading him to conclude that there was still grounds for caution.

Richard Fisher reacted to the observations made by Jean Pisani-Ferry, and explained his views on the reasons for the productivity surge: before the crisis, the United States went through an inflationary scare as a more prosperous world "moved up the protein ladder" and drove the cost of inputs upwards. With limited pricing power, US firms had no choice but to "*drive productivity even harder*". **Richard Fisher** mentioned that in this regard, "*cyberisation*" (the use of IT products) was a powerful driver. Turning to structural unemployment and potential output, he expressed his

scepticism both at the concept (to the extent that in a globalised world, capacity is defined by domestic and international developments) and at the ability to measure it.

The floor was opened to questions following the three presentations. One of the participants asked what "large external force" could prompt change in the United States. **Richard Fisher** responded that "*if you want to come back as being truly omnipotent (E), you come back as the bond market*", paraphrasing a quote by James Claville. Current financing conditions are attractive, but there is a limit "*until the market gets a gag reflex".*

Another participant asked about the dollar's evolution as a reserve currency, and the risk of protectionism. **Richard Fisher** stated that he saw only two options for deep pools of liquidity, the dollar and the euro, and that these currencies owed their attractiveness to the conduct of monetary policy. Commodity backing wasn't going to happen, he stated, and the SDR – the "Esperanto" of currencies – was too unpractical to constitute a realistic alternative. Turning to the second question, he stated that "*protectionism is the syphilis of economics"* and that the Great Depression had clearly shown the price paid by creating obstacles to trade. **Bruce Stokes** added that protectionism had been at the forefront of policymakers' and observers' fears during the early stages of the crisis, but the risk had never materialised. There was simply no momentum for protectionist policies in the US Congress anymore, and there likely wouldn't be in the foreseeable future.