OPINION

A Two-Track Plan to Restore Growth

By John B. Taylor

It's been three years since the financial crisis flared up and the recession began. Yet the unemployment rate is still over 9%—double what it was before the recession—and it's been stuck above 9% for 20 consecutive months. Why the extraordinarily high and prolonged unemployment? My research shows that discretionary government interventions—deviations from sound economic principles and policies—have been largely responsible.

Our economic wounds are self-inflicted. Changing fiscal and monetary policies could make a difference fast.

Many government interventions occurred before the panic in the fall of 2008, but in the past two years the government doubled down. We have seen an $862 billion stimulus, an increase in federal spending to 25% from 21% of GDP, and a corresponding explosion of federal debt. We have the Fed's unconventional "quantitative easings": purchases of $1.25 trillion of mortgage backed securities and $900 billion of longer-term Treasury bonds. And we have seen hundreds of new regulations in the health and financial sectors.

The one-time stimulus payments to people did not jump-start consumption. The stimulus grants to states did not increase infrastructure spending. Cash for clunkers merely shifted consumption a few months forward. The Fed's purchases did not have a material impact on mortgage interest rates once changes in risks are taken into account. At best these actions had a small temporary effect that dissipated quickly, leaving a legacy of higher debt, a bloated Fed balance sheet and uncertainty—all of which slow growth and job creation.

None of this should be surprising. Well-known theories of consumption predict that temporary payments to households will not increase economic growth by much. Careful empirical studies of stimulus programs in the 1970s showed that stimulus grants to states did not increase infrastructure spending. A vast literature and experience from the 1970s show that discretionary monetary policy, as distinct from rules-based policy, leads to boom-bust cycles with ultimately higher unemployment and higher inflation. With sounder, more stable and more predictable monetary and fiscal policies in the 1980s and '90s we had long expansions and lower unemployment.

The best way to reduce unemployment is to restore sound fiscal and monetary policies. There are some welcome signs that the policy pendulum has begun to swing back in that direction. The recent election revealed deep concern about high debt, deficits and spending.

Three-fourths of business economists and one-half of academic economists say that easy monetary policy exacerbated the housing boom and bust that led to the financial crisis. Reactions to a second round of quantitative easing have been negative at home and abroad. The very word "stimulus" is now avoided by former proponents of spending stimulus. The recent agreement to extend existing income tax rates represents a shift to more predictable policies.

Unfortunately, the president's State of the Union speech raised doubts about the return to sound policy by stressing more government spending and criticizing further extensions of current personal income tax rates. So it is essential for policy makers to grab the policy pendulum, pull it back toward sound fiscal and monetary policy, and tie it in place so it never swings back again.

They should start by laying out a credible plan to reduce spending and stop the debt explosion. If spending as a share of GDP can be brought to 2000 levels and held there with entitlement reforms, then the budget can be balanced without employment-retarding tax-rate increases. A concrete goal should be to establish a long-term budget that the Congressional Budget Office (CBO) can credibly show would bring the debt-to-GDP ratio to 40%. If the plan is ready for this summer's CBO long-term projections, it will give an immediate boost to economic growth and job creation as uncertainty about debt sustainability falls. An example of what the CBO's next projection might look like is shown in the nearby chart of U.S. debt history along with the CBO's projections made in 2009, 2010 and, if the plan is ready, in 2011.

Some want to delay reducing government spending because of high unemployment and the fragile recovery. But there is no convincing evidence that a gradual and credible reduction in government purchases will increase unemployment. The history of the past two decades shows that lower government purchases as a share of GDP are associated with lower unemployment rates. A much better way to reduce unemployment is to encourage private investment. Over the past two decades, unemployment fell when investment increased as a share of GDP. (See the other nearby chart.)

Meanwhile, the Fed should lay out a plan for reducing its extraordinarily large balance sheet. To achieve a more predictable rules-based policy going forward, the Fe objectives should be clarified. The Federal Reserve Act now says the Fed must "promote effectively the goals of maximum employment, st ble prices, and moderate long-tern interest rates." But too many goals blur responsibility and accountabil ity and they allow for confusing changes in emphasis from one goa to another.

Recently the multiple objective: have been used as a rationale for i terventionist policies, such as QE2 an approach that Fed officials avoided in the 1980s and '90s. Suc interventions can have the unintended consequence of increasing unemployment—as illustrated by t decisions to hold interest rates ve low in 2003-2005, which may have caused a bubble and led to the hig unemployment today.

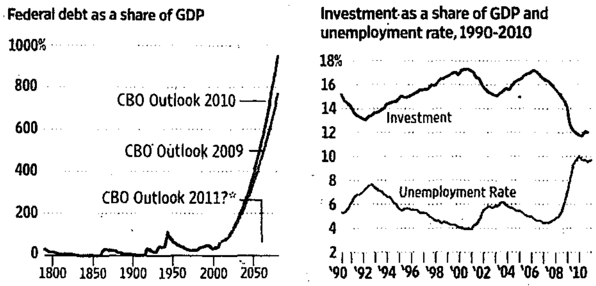
It would be better for economic growth and job creation if the Fed' objective was simply "long-run pri stability within a clear framework economic stability." Such a goal would provide a foundation for strong employment growth and would not prevent the Fed from pr viding liquidity, serving as lender (last resort, and cutting the interes rate in a financial crisis or recessic

The Fed should also be required to report in writing and in hearing its strategy for monetary policy. Such a requirement was removed b Congress in 2000 and should be re stored. But rather than reporting only on the monetary aggregates a in the past, the renewed requireme should focus on the strategy for se ting interest rates. The Fed should establish its own strategy and repc it to Congress.

The Fed would have the discretion to deviate from its strategy in crisis. But if it does deviate it shou be required to report the reasons. This approach provides a degree o political control and accountability appropriate for an independent agency without interfering in day-t day operations. Such reforms will r verse the short-term focus of polic and help achieve sustained growth and job creation.

Mr. Taylor, a professor of economics at Stanford and a senior fe low at the Hoover Institution, is the author of "Getting Off Track: How Government Actions and Interventions Caused, Prolonged and Worsened the Financial Crisis" (Hoover Press, 2009). This op-ed was adapted from his testimony before the House Committee on Financial Services this week.

More Private Investment Means More Jobs



*If budget brings debt-to-GDP ratio to 40%
Sources: Congressional Budget Office, Taylor

Sources: U.S. Department of Labor, U.S. Department of Commerce