Key to Restoring America's Prosperity: A Turning Point in Economic Policy

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Prepared for the session

"**Restoring Prosperity and Government Policy Reforms**"

at the conference

"**Restoring Prosperity:**

Contemporary and Historical Perspectives,"

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FIRST PRINCIPLES

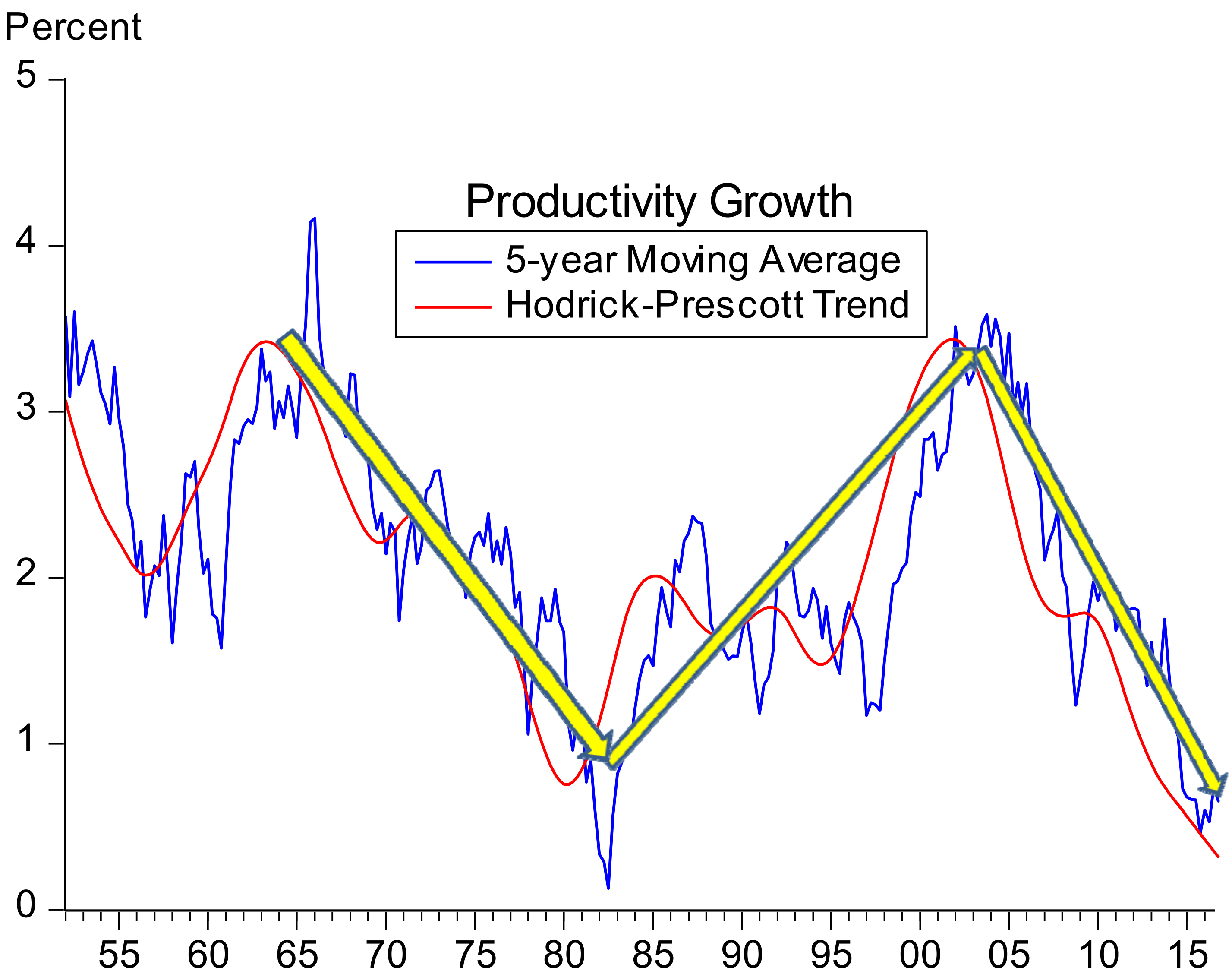
Five Keys to Restoring America's Prosperity

JOHN B. TAYLOR

Winner of the Hayek Prize

Past Turning Points in Economic Policy

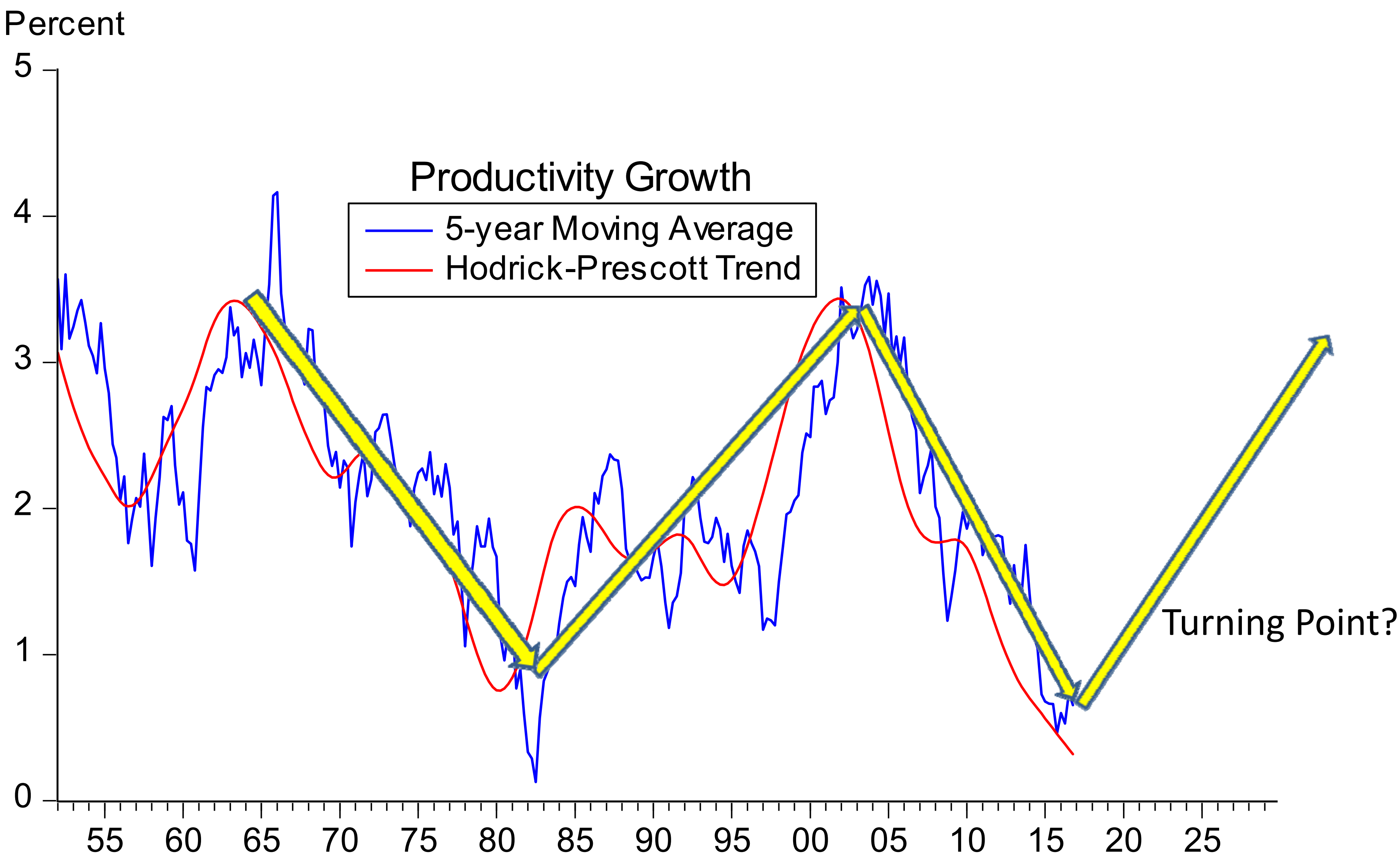
- 1960s-1970s
  - Shifting away from key principles
- 1980s-1990s
  - Swinging back toward the principles
- 2000s-2010s
  - Veering away again



Percent
5
4
3
2
1
0
Productivity Growth
5-year Moving Average
Hodrick-Prescott Trend
55
60
65
70
75
80
85
90
95
00
05
10
15

Past and Future Turning Points in Economic Policy

- 1960s-1970s
  - Shifting away from key principles
- 1980s-1990s
  - Swinging back toward the principles
- 2000s-2010s
  - Veering away again
- Now and going forward
  - Swinging back toward the principles?


Percent
5
4
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85
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95
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05
10
15
20
25
Productivity Growth
5-year Moving Average
Hodrick-Prescott Trend
Turning Point?

A Successful Turning Point Depends on Two Things

First is the strength of the underlying support for the economic principles.

- Tax Reform
- Regulatory Reform
- Monetary Reform
- Budget Reform

Second is the ability or commitment of public officials who support the economic principles in theory to take on the difficult task of implementing them in practice.

Tax Reform

- A close congruence between the Administration and Congress on basic principles of tax reform
- Also close on many implementation details
  - Personal side: lower rates and expand base
  - Corporate side: reduce tax rate, expense investment, no deduction for interest, territorial tax regime
- But disagreements about “border adjustment.”

Regulatory Reform

- Close congruence on principles
- Executive Orders
  - Core Principles for Regulating the U.S. Financial System (Feb 3)
  - Reducing Regulation and Controlling Regulatory Costs (Jan 30)
- Legislation
  - Choice Act (Chapter 14 , capital/compliance)
  - REINS Act (requires congressional approval for >$100 million)
  - Regulatory Accountability Act (choose least costly option, prohibit action while challenged in court, end “Chevron deference.”)
  - Repeal specific regulations using the Congressional Review Act
- Disagreements on Trade: TPP, NAFTA,…
  - “America first”
  - “the right of all nations to put their own interests first.”
  - Analogies with the Structural Impediments Initiative

Monetary Reform

- Legislation
  - FORM Act (Part of CHOICE Act) would require that Fed “describe the strategy or rule of the FOMC for the systematic quantitative adjustment” of policy instruments.
- Other monetary actions
  - International Monetary Reform: Each country reports and commits to its monetary strategy and thus helps build the foundation of the international monetary system
  - Transparency and exchange rate policy

Budget Reform

- Discretionary countercyclical fiscal policy popular in 60s, 70s
- Budget reform, fiscal consolidation, automatic stabilizers gained favor in 80s & 90s
- Then tide moved back to discretionary stimulus programs.
  - large fiscal stimulus in 2001, 2008, 2009, 2012
- **So clearly at fiscal turning point**
  - Research shows that fiscal stimulus is not the way to go

Wall Street Journal, Monday, October 24, 2016

Last Week: **DJIA** 18145.71 ▲7.33 0.04% **S&P** 2141.16 ▲0.38% **NASDAQ** 5257.40 ▲0.83% **10-YR. TREAS.** ▲15/32, yield 1.740% **OIL** $50.85 ▲$0.10

Fiscal Stimulus Wins More Fans

Investors support government spending as central-bank moves fail to ignite growth

BY JON SINDREU

ABREAST OF THE MARKET

A growing number of investors and policy makers, seeing central banks as powerless to revive an anemic global economy, are championing a resurgence of fiscal spending.

A move away from central-bank-led policy, and toward the use of the government's taxing-and-spending power to revive growth, would end a yearslong economic era and could cause upheaval in financial markets.

Investors, among them bond king Bill Gross, once feared that government profligacy was a death knell for sovereign bonds. Back in 2011, Mr. Gross dumped U.S. Treasurys and declared that U.K. government bonds were resting "on a bed of nitroglycerin."

Today, he is calling for more government spending.

It is far from clear that the shift is yet upon the world—especially Europe and Japan, which are deep into the unprecedented monetary experiment of negative interest rates. But there are glimmers that it is coming.

The U.K. is wrestling with the market and economic effects of its June vote to leave the European Union. This month, the prime minister bashed loose monetary policy while her Treasury chief talked up spending on infrastructure and housing. Other European countries have eased off the austerity that defined their response to the continent's yearslong debt crisis.

And the International Monetary Fund, once a proponent of budget cuts, now urges governments to spend more.

For several years, governments have feared incurring more debt to do so. Instead, they have left it to central banks to lower the cost of borrowing and thus encourage households and businesses to spend.

That hyperactive monetary policy has pushed up prices of assets—including bonds—and damped market volatility. Except for the occasional "tantrum," stocks and government bonds have marched ever upward.

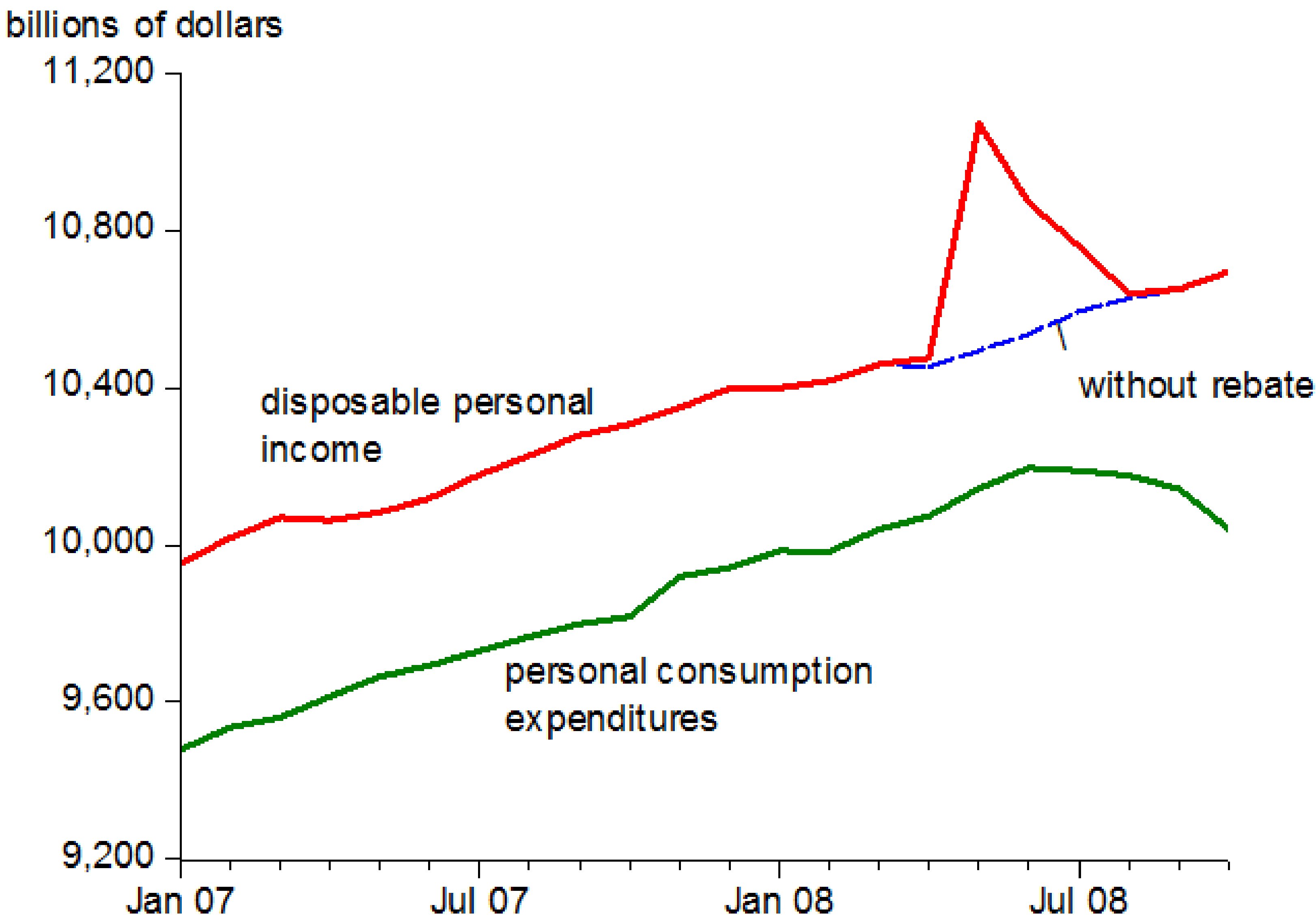
But there is growing evidence that central-bank policy is underwhelming: Households and businesses haven't gone on a spending binge. What's more, the policy has come at a cost to commercial banks, which have seen their profits compressed at a time when many are already weak.

So policy makers are toying with the old idea of having the government do the spending. Such a change, were it to come to fruition, isn't likely to have the same salutary effect on stocks and bonds as central-bank stimulus, which relies on pushing up the value of financial assets.

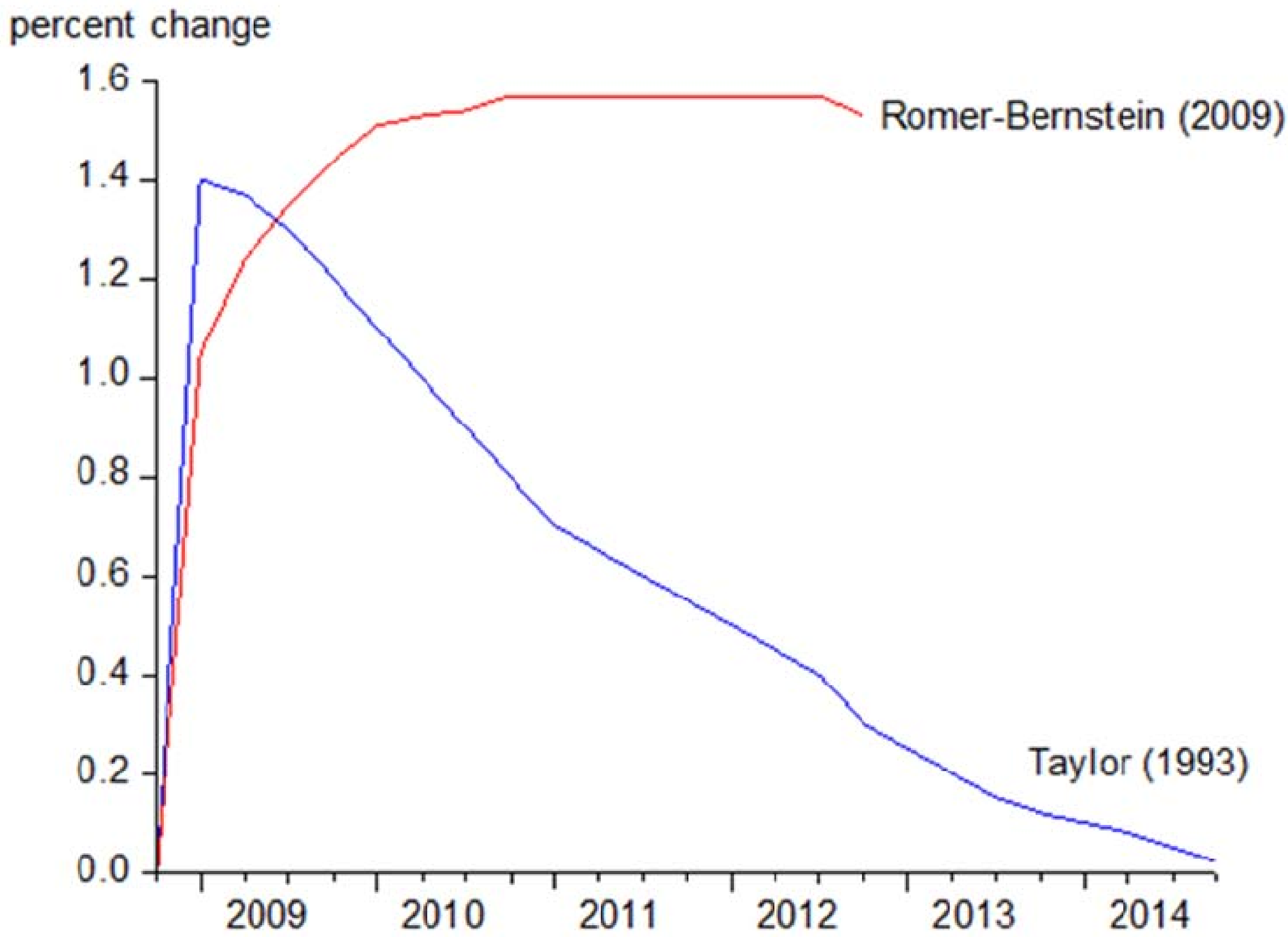
"We are leaving this very certain, very comfortable invest-

Please see FISCAL page C3

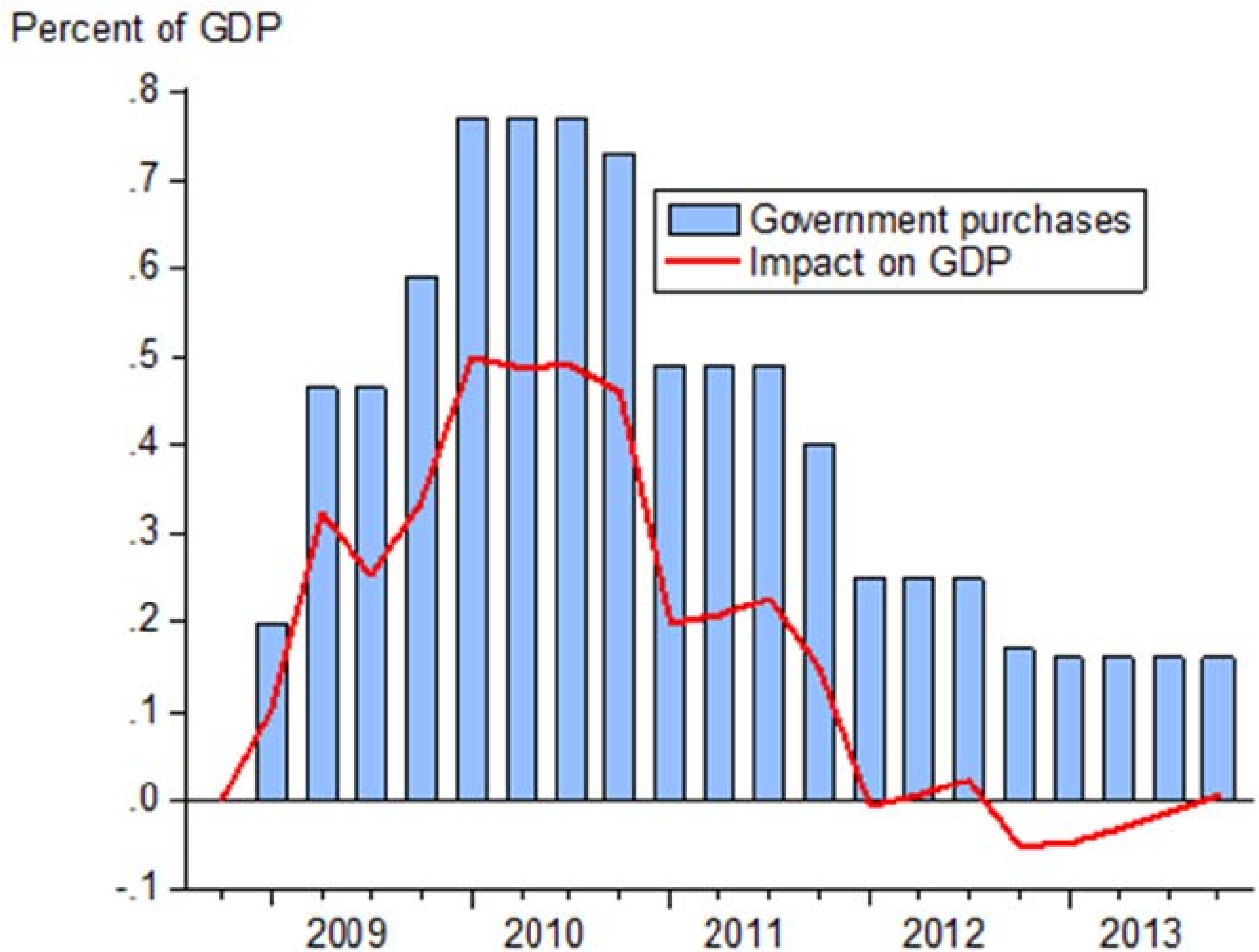
◆ Election lifts hopes of infrastructure spending........ C3



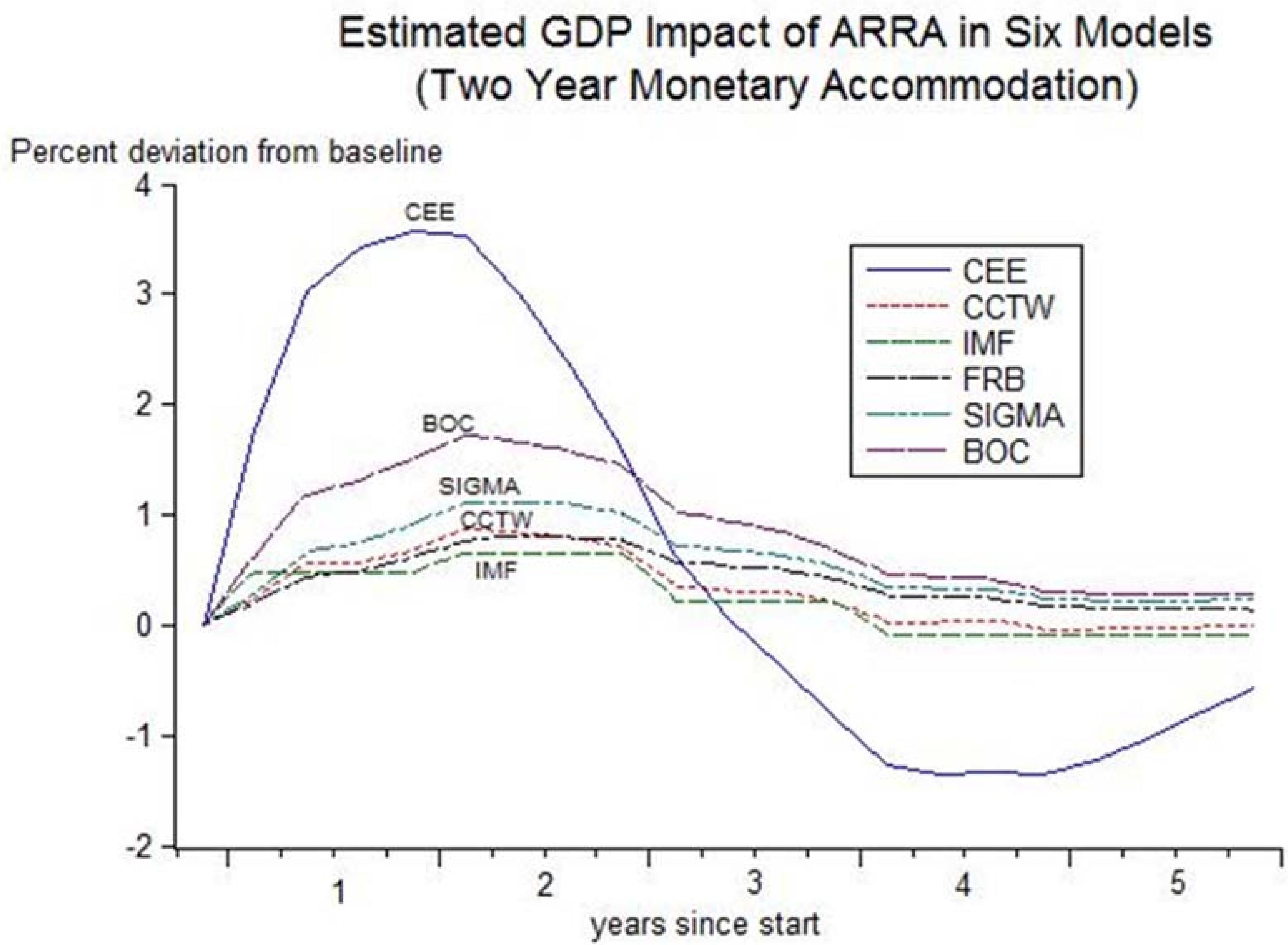
Income, Consumption, and the 2008 Rebate Payments



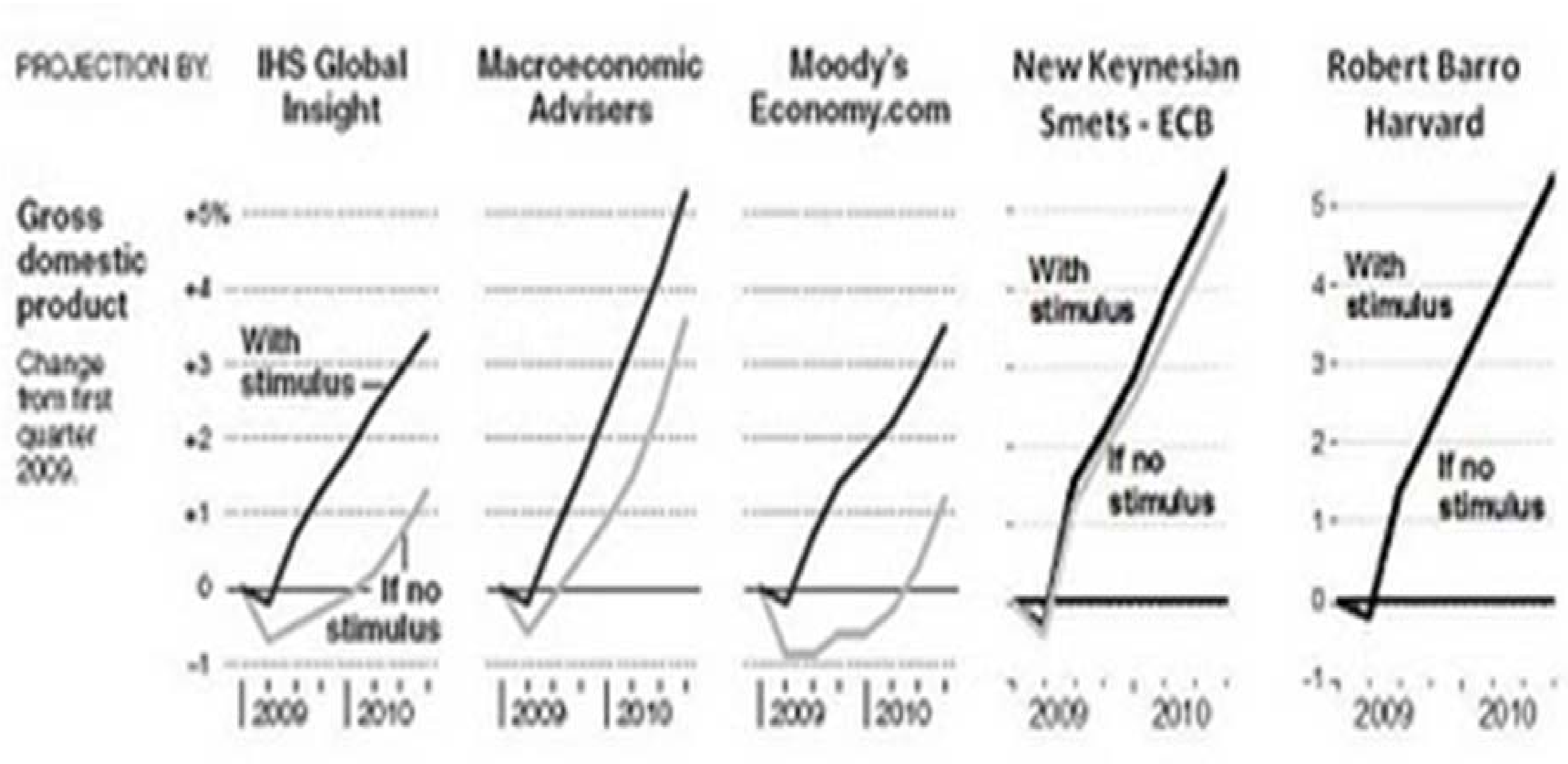
Old Keynesian versus New Keynesian



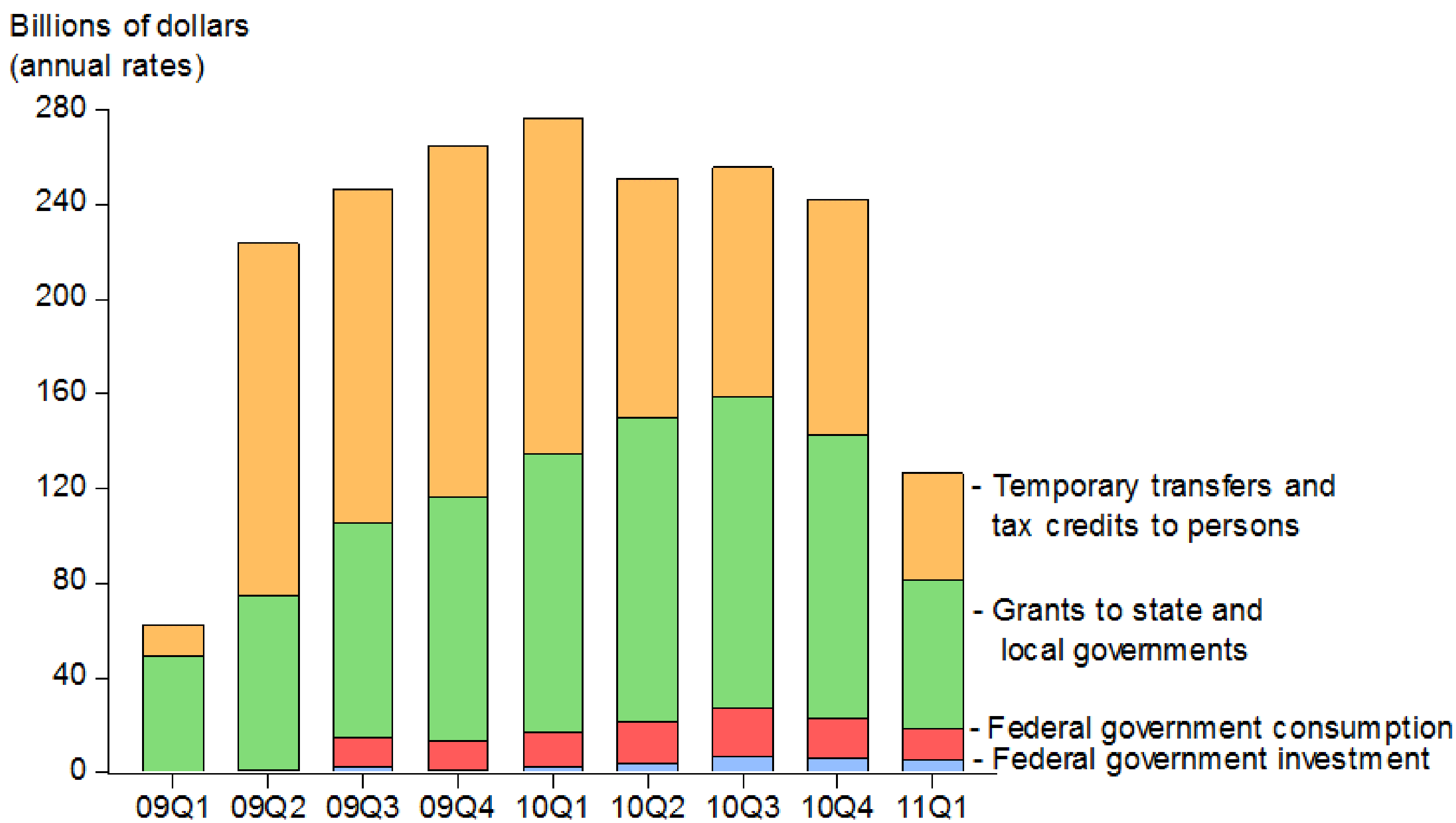
Impact of 2009 stimulus package; from Cogan, Cwik, Taylor, Wieland



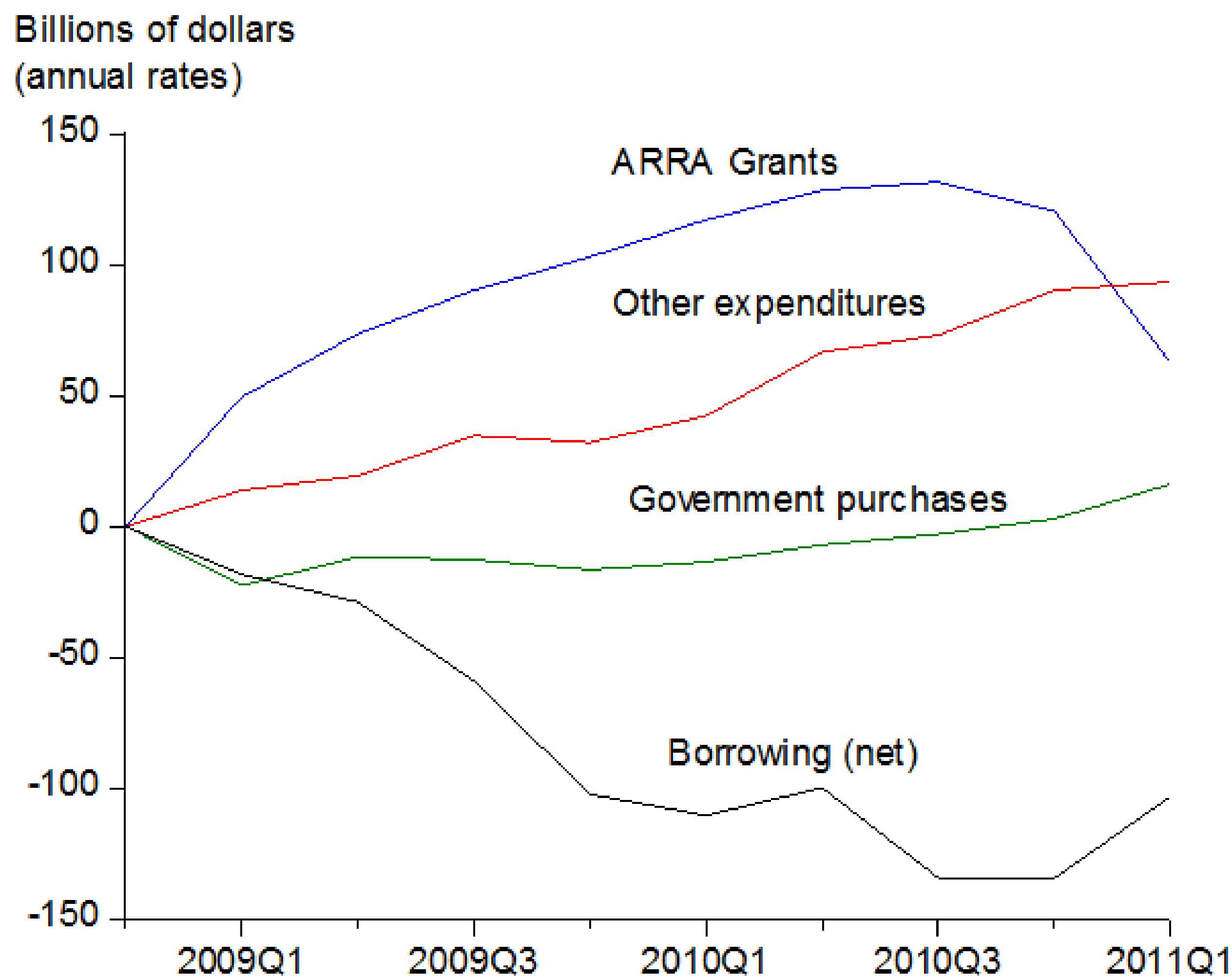
Estimated GDP Impact of ARRA in Six Models
(Two Year Monetary Accommodation)
Percent deviation from baseline
4
3
2
1
0
-1
-2
CEE
BOC
SIGMA
CCTW
IMF
CEE
CCTW
IMF
FRB
SIGMA
BOC
1
2
3
4
5
years since start



Ex post evaluation of stimulus packages:
3 old Keynesian models and 2 alternatives.



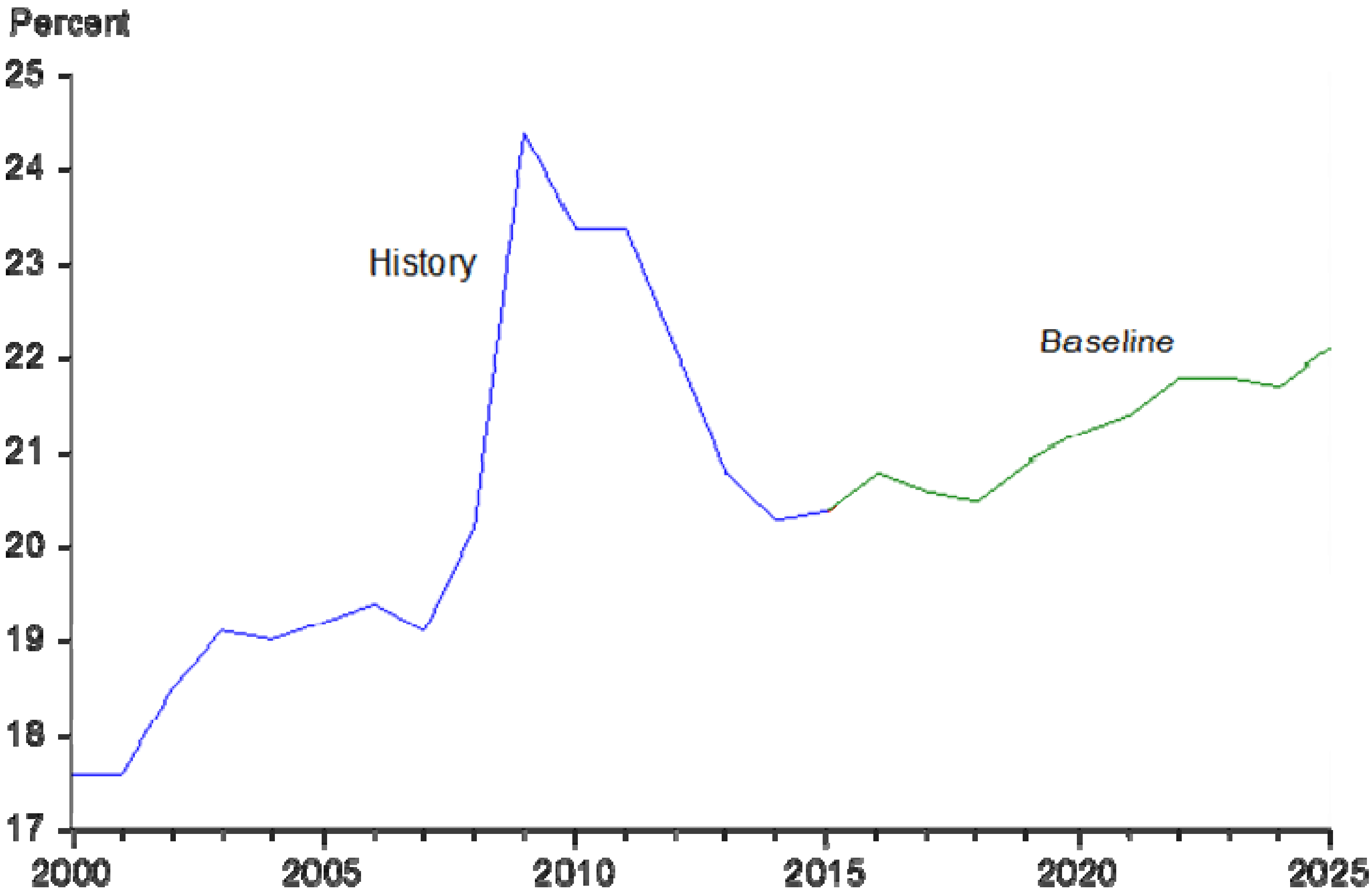
Major Federal Budget Categories of ARRA



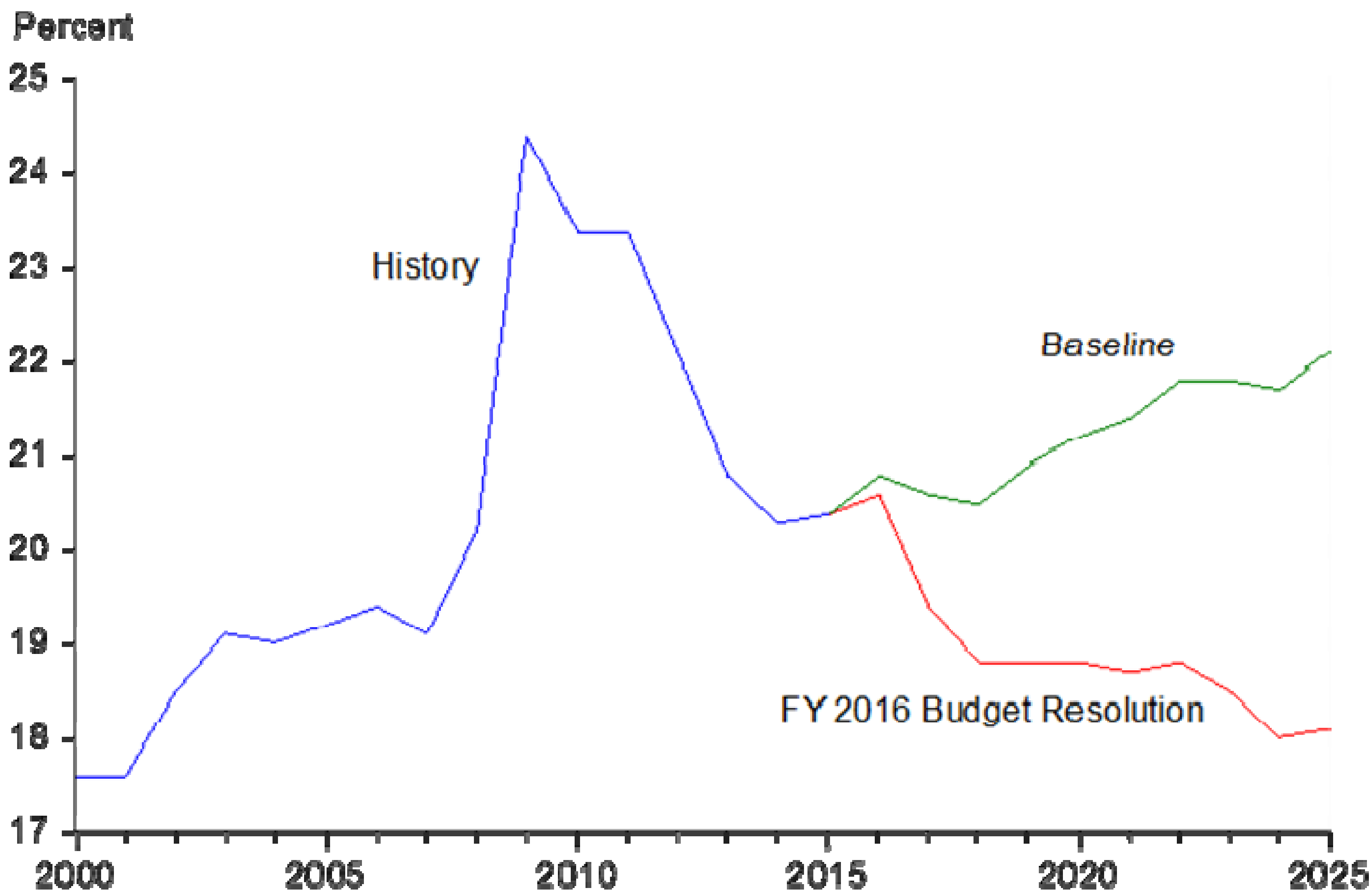
ARRA Grants and State and Local Budgets
(change from 2008.4 when ARRA grants were zero)

Fiscal Consolidation

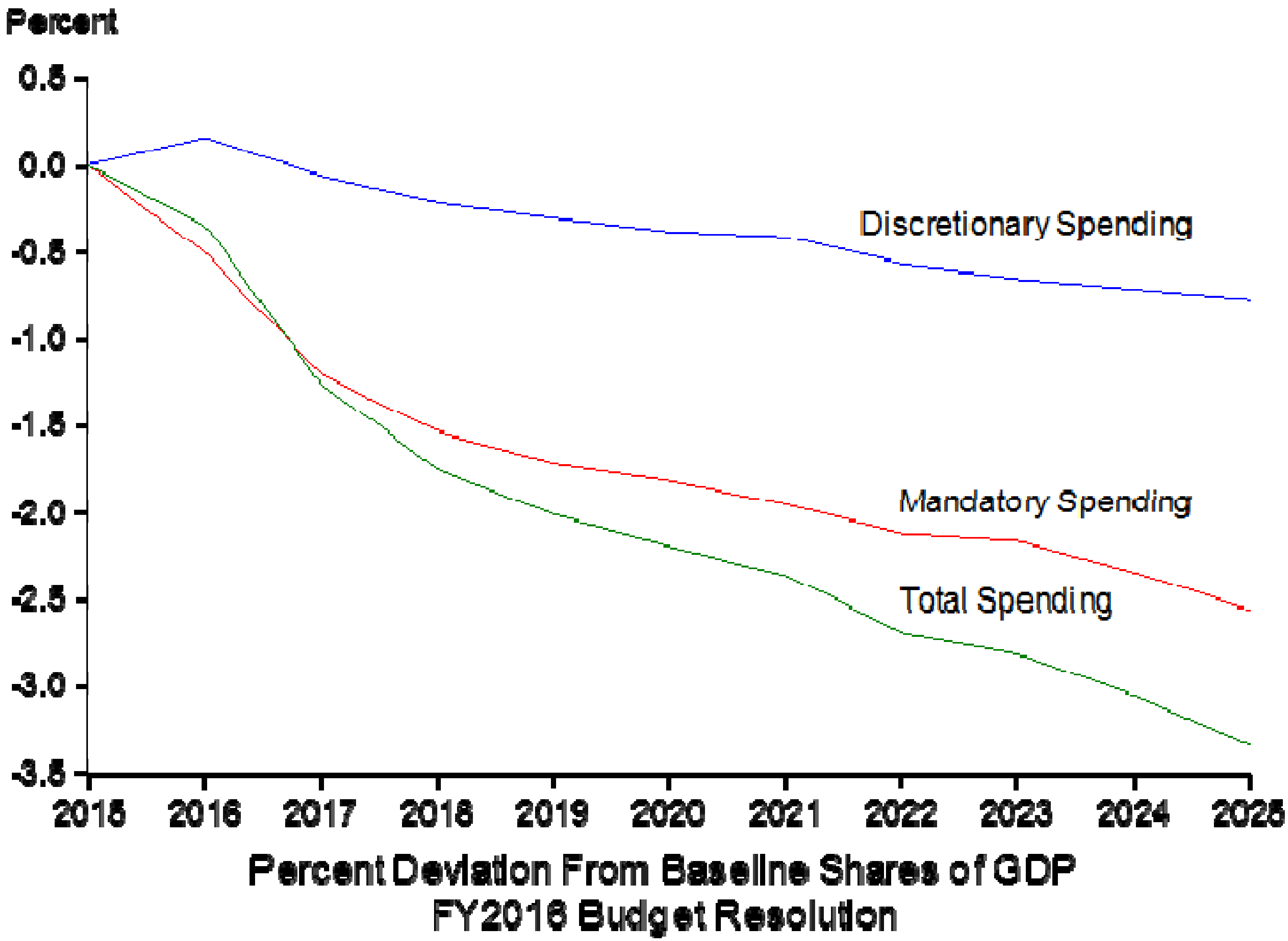
- Consider recent House Budget Resolution...

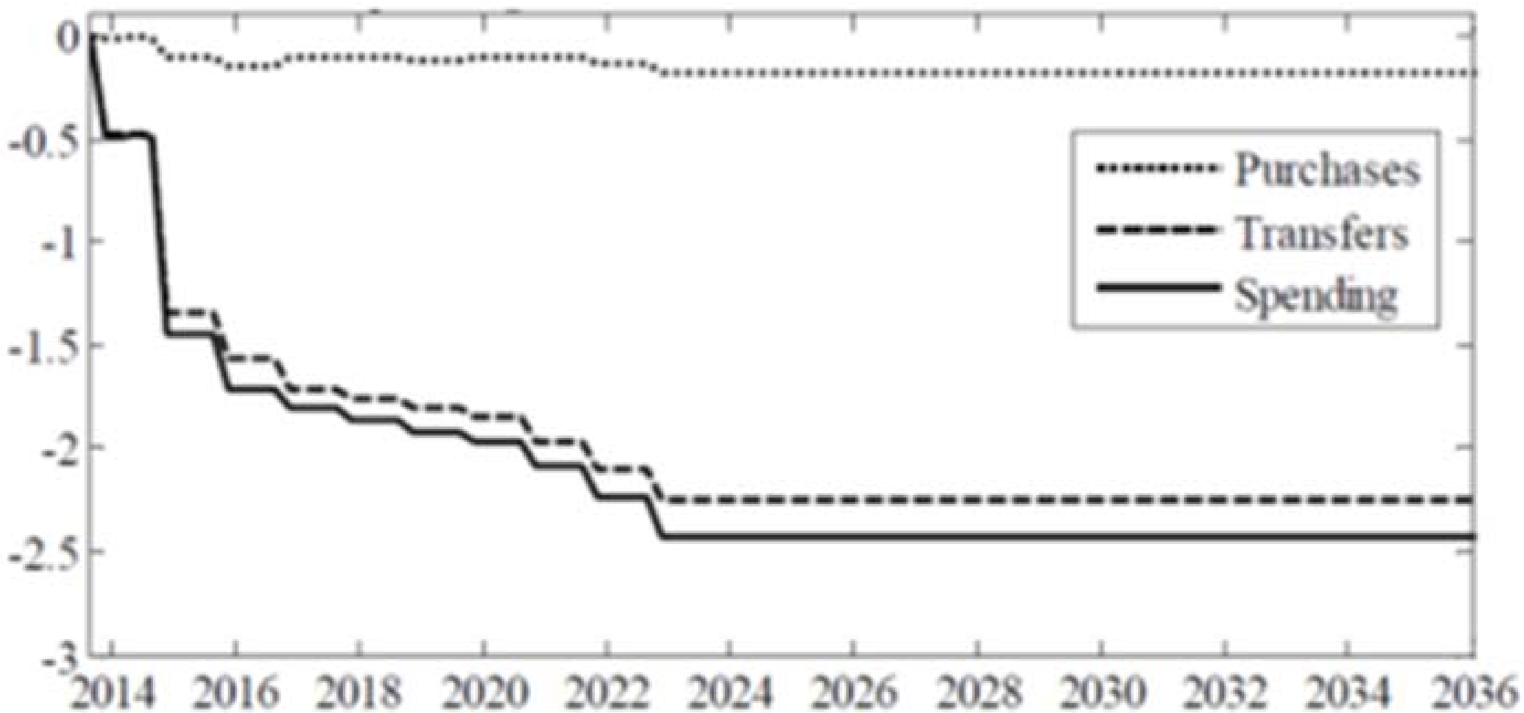


Federal Government Outlays as a Percent of GDP

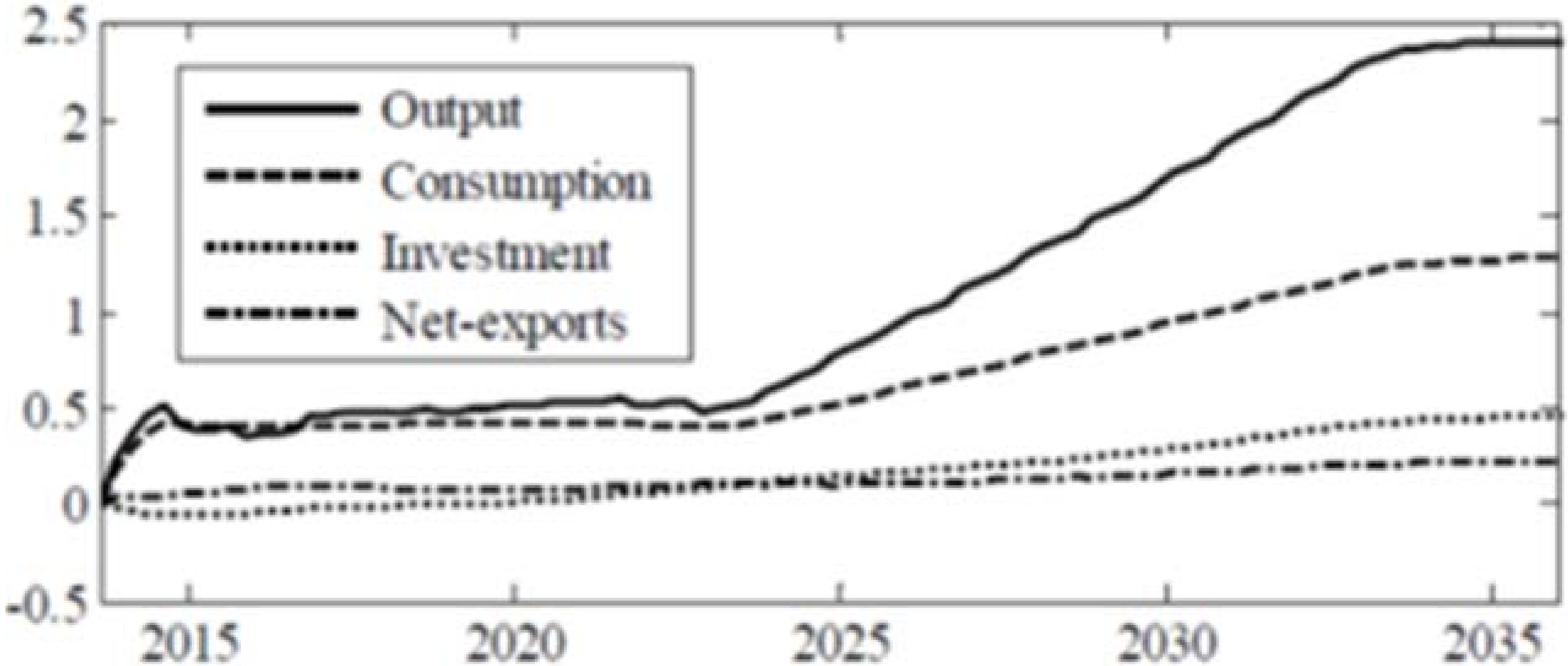


Federal Government Outlays as a Percent of GDP


Percent
0.5
0.0
-0.5
-1.0
-1.5
-2.0
-2.5
-3.0
-3.5
Discretionary Spending
Mandatory Spending
Total Spending
2015
2016
2017
2018
2019
2020
2021
2022
2023
2024
2025
Percent Deviation From Baseline Shares of GDP
FY2016 Budget Resolution

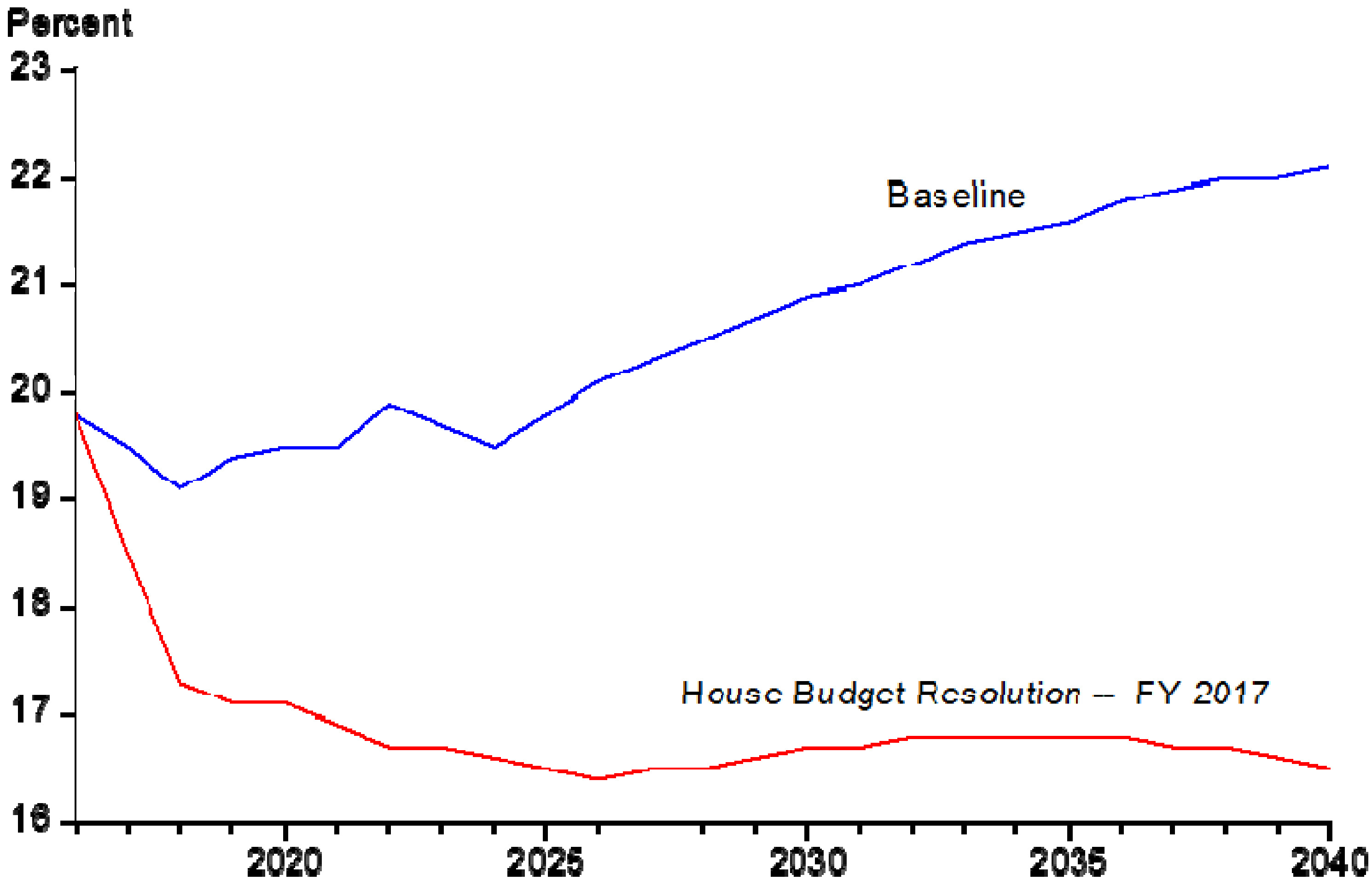


Fiscal consolidation strategy: percentage deviation of purchases, transfers and spending from baseline as a share of GDP

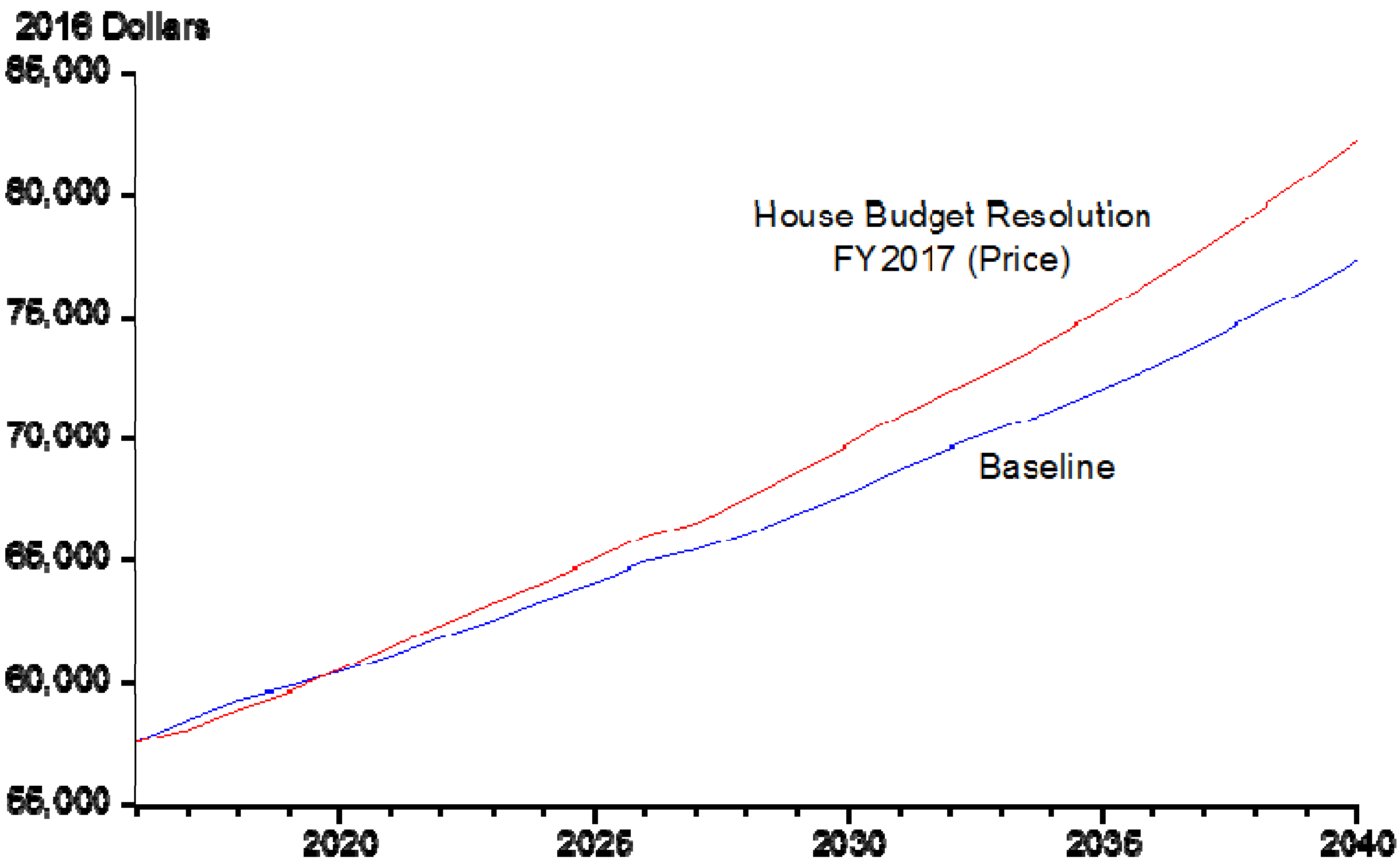


Estimated Impact of Fiscal Consolidation

Positive in Both Short run and Long run

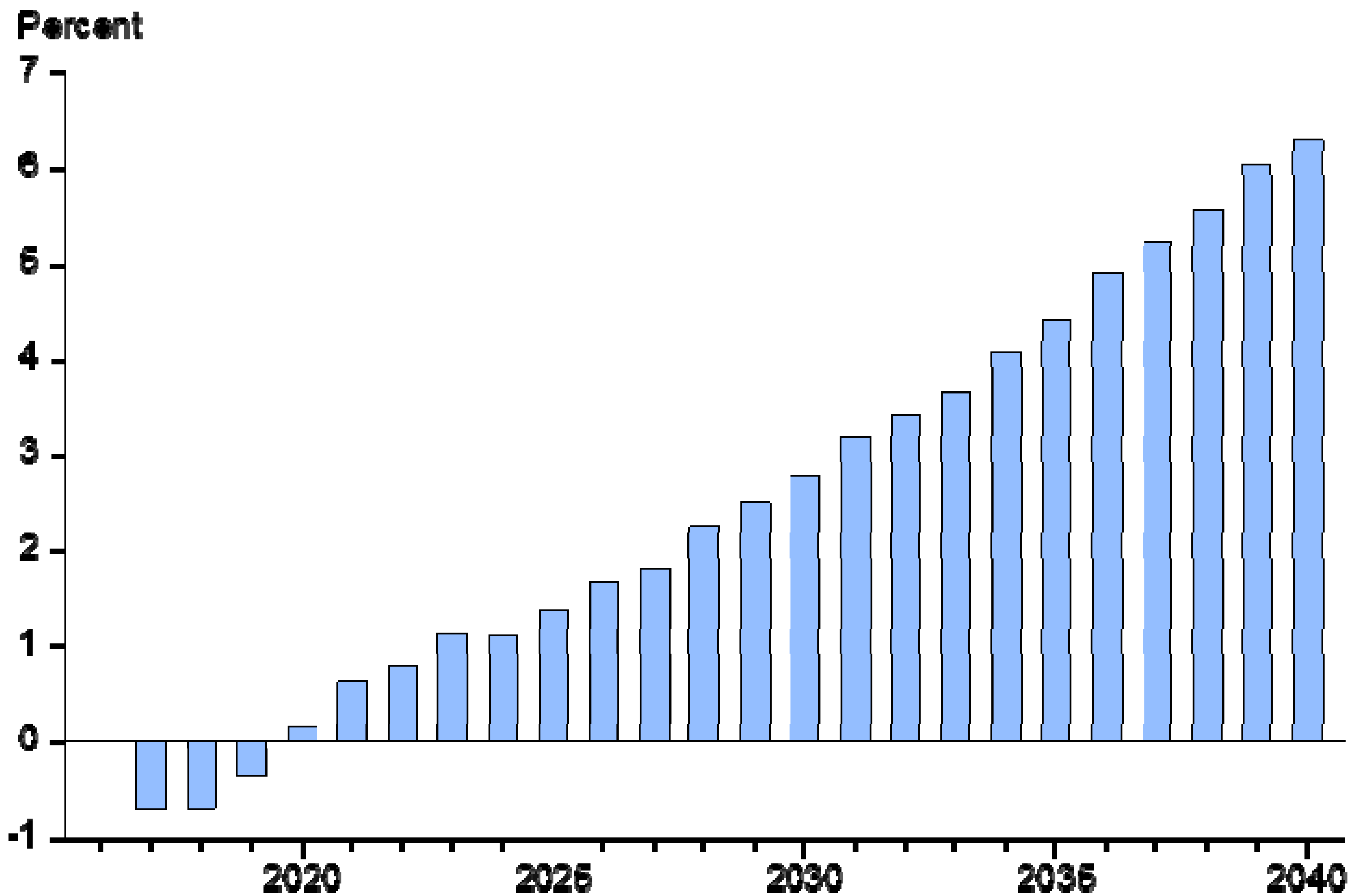


Non-Interest Federal Outlays as a Percent of GDP



Real GNP per Person. 2016 dollars

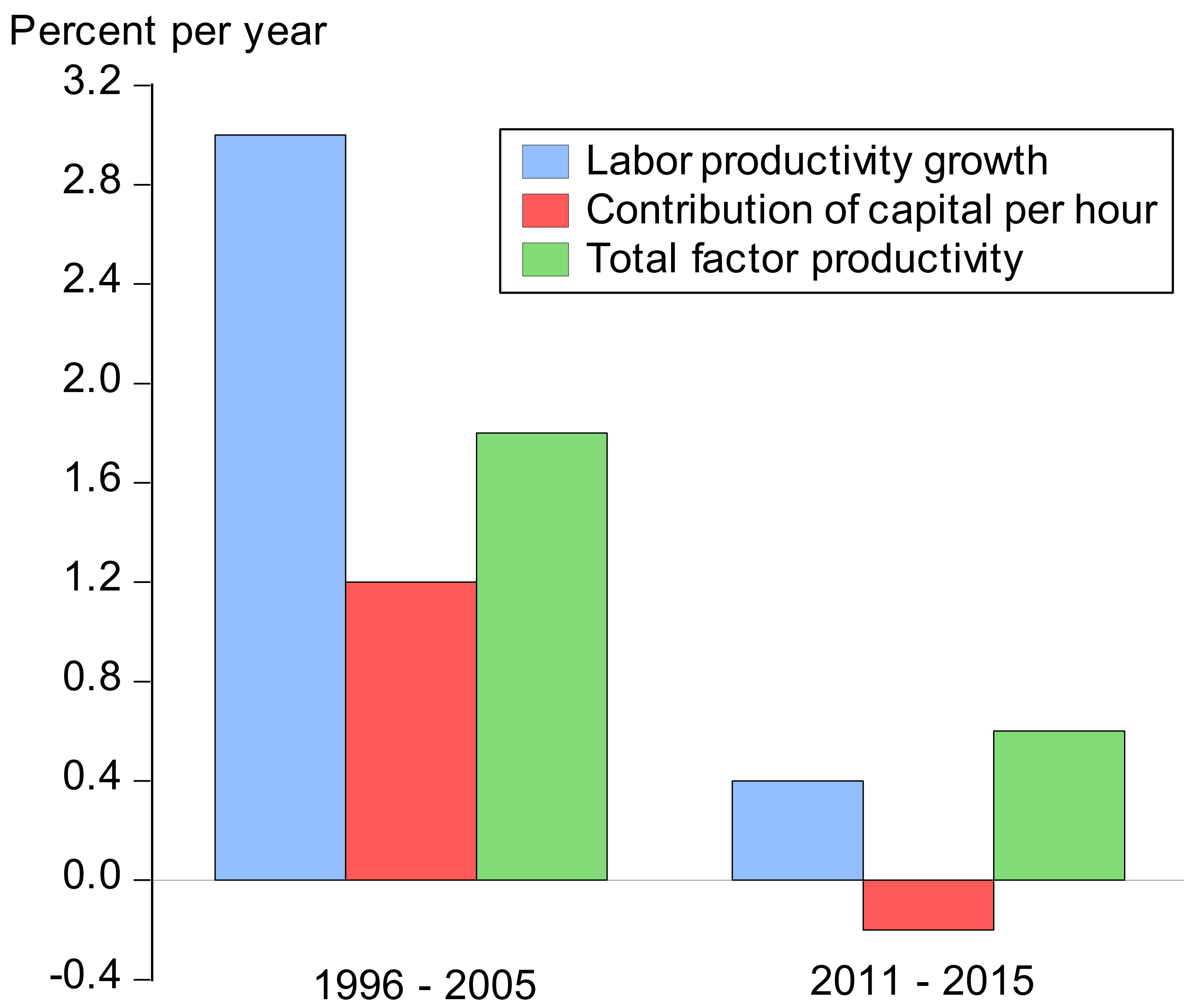
CBO Estimates



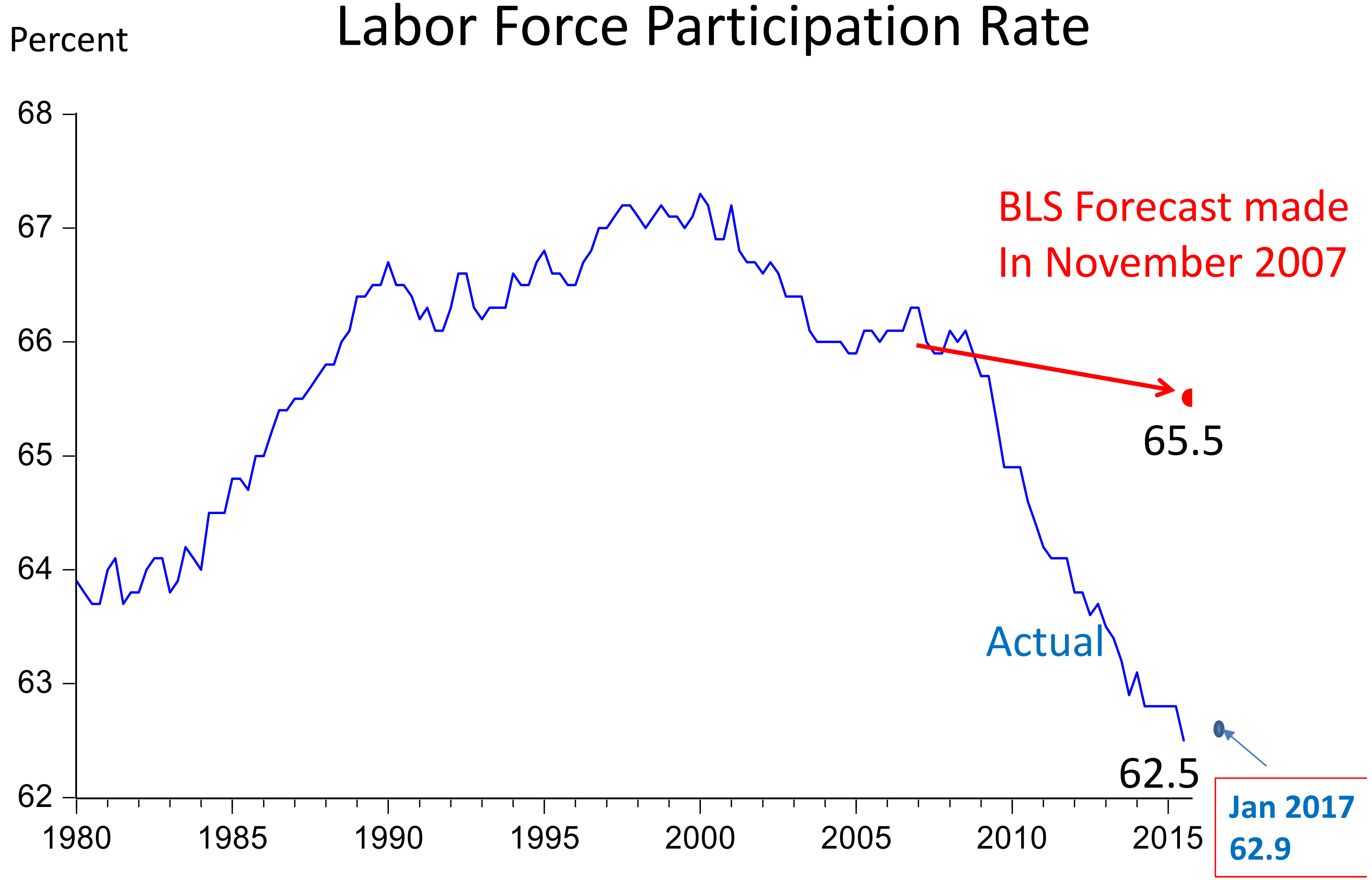
CBO Estimates of the Effects of House Budget Resolution for FY2017 (Price) on Real GNP Per Person as a Percent of Baseline

CBO Estimates

How fast can a turning point restore prosperity?


Percent per year
3.2
2.8
2.4
2.0
1.6
1.2
0.8
0.4
0.0
-0.4
Labor productivity growth
Contribution of capital per hour
Total factor productivity
1996 - 2005
2011 - 2015

Labor Force Participation Rate



Conclusion

- A turning point in economic policy will go a long way to restoring prosperity
- In assessing chances of such a turning point consider
    1. Degree of agreement on economic principles
        - Good, but still need to work out some differences
    2. Implementation, which is now key.