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POLITICS

Looming Big Fiscal Tightening Will Complicate Fed's Exit Plans

By SCOTT STODDARD, INVESTOR'S BUSINESS DAILY

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Federal Reserve Chairman Ben Bernanke testifies on Capitol Hill on March 25. The Fed has ended most of its emergency lending programs but likely will... View Enlarged Image

The government and the Federal Reserve are winding down massive stimulus programs as the economy recovers. But can they both exit at the same time without sending the economy back into recession?

The Fed has ended most of its emergency lending programs but likely will reiterate Wednesday that it plans to leave interest rates near 0% for "an extended period" to support the budding recovery. Policymakers also will likely take no action on the Fed's mortgage securities holdings, though some officials have signaled they want to start paring its balance sheet.

Meanwhile, the record $787 billion in federal stimulus spending and tax breaks is peaking now and political opposition to more spending is mounting. The budget deficit, which soared to 9.9% of GDP in fiscal 2009, is slated to fall to 9.2% in 2010, 6.5% in 2011 and 4.1% in 2012 as stimulus and Bush-era tax cuts expire, according to the Congressional Budget Office.

Intense Fiscal Head Winds

So the U.S. economy faces almost unprecedented fiscal head winds over the next few years, making the Fed's job even harder.

"We want to avoid the 1937 mistake where we withdrew liquidity too early" and prolonged the Great Depression, said Don Rissmiller, chief economist at Strategas Research Partners.

If the Fed aggressively tightens monetary policy as fiscal screws are turned, the moderate economic recovery could falter. But if it takes too long, inflation could flare up.

"The hard part is getting the interaction effects right" when it comes to monetary and fiscal policy, Rissmiller said.

So far, the Fed has stopped buying Treasuries and mortgage securities, part of unprecedented emergency measures to unfreeze credit markets. That halt has had little negative impact on the recovery.

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The economy expanded at a 5.6% annual rate in Q4. Analysts think the Q1 GDP report, due out Friday, will show a 3.3% gain. Meanwhile, inflation remains tame.

"There's an increasing sign of broad-based support for the expansion," said Dana Johnson, chief economist at Comerica Bank. "The economy is not going to go south."

Manufacturing is expanding, employers have started to add jobs while home sales and prices have stabilized. But job growth isn't sufficient to reduce joblessness, now 9.7%. And the tax credit that has propped up housing ends April 30.

Japan provides a model of what not to do. It has struggled to withdraw fiscal or monetary stimulus for over a decade. In 1997, a sales tax hike cut short a nascent recovery. In the past decade, various governments and the Bank of Japan often have bickered, urging the other to take more action.

Some analysts say the U.S. economy has gotten remarkably little boost from Washington's record stimulus. About 73% of National Association for Business Economics members polled say that employment at their company is neither higher nor lower as a result.

Some argue that the deficit spending hasn't helped and instead will only lead to higher taxes and lower business investment.

"The large exploding debt is damaging to the economy right now because businesses small and large aren't going to invest as much," said Chris Edwards, director of tax policy at the libertarian Cato Institute.

But other economists say more government spending is necessary to help fuel the economy and that revenue from future growth can be used to pay down deficits run up during the recession.

"If we decide to target lower budget deficits, we'll get lower growth with it," said Josh Bivens, an economist at the liberal Economic Policy Institute. "I don't see a private sector out there that will make up for the ramping down of stimulus."

Business spending has rebounded sharply in recent months. Consumer spending also has perked up from pent-up demand and rebounding asset values. But high unemployment and tight credit may mute shoppers going forward.

Should the economy falter, Washington may not offer much help, as voters rail against record deficits and corporate bailouts. And because projected deficits are seen as unsustainable long term, markets may start to demand that the U.S. get its finances in order.

Bivens said politicians worried that massive stimulus will fuel inflation may pressure the central bank to retrench prematurely.

"People are going to tell the Fed they're flirting with inflation and there's going to be political pressure to raise interest rates before too long," he said.

No Need To Rush

But with economic growth likely to remain weak and unemployment high for years, Bivens said inflation fears are overblown.

"You want to see evidence of a robust economic recovery before you want to see monetary and fiscal policy tighten," he said.

Raising rates also could push up Treasury yields, exacerbating the government's massive debt woes.

Johnson, a former Fed economist, noted the central bank and federal government must enact and unwind stimulus in every economic cycle. So far, he said, the pace of withdrawal seems on track.

"It is time to begin to withdraw stimulus," he said. "The economy doesn't need it any more."

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