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FEDERAL GOVERNMENT IN BETTER POSITION THAN FEDERAL RESERVE TO SUPPORT FALTERING ECONOMY, LEVY SCHOLAR SAYS

New Policy Paper Says Fiscal Stimulus and Regulation Are Needed to Support Economy and That There's Not Much More Monetary Policy Can Do

ANNANDALE-ON-HUDSON, N.Y.—As financial markets continue to tumble—as unemployment grows, inflation threatens, the housing market declines, and the trend in subprime mortgage defaults spreads into prime mortgages and home equity and other secondary loans—it is clear the U.S. economy is still mired in a financial crisis. The outlook overseas only adds to the gloom. As policymakers and pundits continue to debate remedies for the crisis, a new policy paper from The Levy Economics Institute of Bard College argues that there's little more that the Federal Reserve can do. In his new policy note, *What's a Central Bank to Do? Policy Response to the Current Crisis*, Levy Senior Scholar L. Randall Wray contends that fiscal policy to boost the economy and regulations aimed at preventing asset bubbles and their consequences are what is needed now.

In his paper, Wray credits the Fed for its efforts to support the economy and guard against liquidity problems—from its quick efforts to lower borrowing costs and promote more favorable refinancing terms for households saddled with onerous subprime mortgage terms to its efforts to rescue Bear Stearns, Fannie Mae, and Freddie Mac—but asserts that the policy is clearly not working "The economy continues to weaken, the financial crisis is spreading, and inflation is accelerating," he writes, stressing that the Fed's policy does not handle bubbles well. Wray says that over the past decade and a half, the "new consensus" monetary activism of guiding interest rates to a neutral rate, spurring neither unemployment nor inflation, amounted to "expectations management." The policy has mostly worked, he contends, allowing for a long period of robust growth and reduced

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economic instability The problem, he says, is that the policy could not prevent bubbles and may actually have helped trigger them, because the relatively long period of economic stability created greatly reduced risks and led to some of the risky financial innovations and practices that contributed to the housing bubble.

To address what he expects will be an extended period of stagflation, Wray suggests a combination of new regulations and fiscal stimulus. To address inflation, he advises targeting commodity futures purchased by managed money funds and oligopoly pricing by oil producers. His recommendations include removing all tax advantages for funds that purchase commodities or indexes of commodities, prohibiting the purchase of such assets by funds that benefit guarantees, and drawing down the Strategic Petroleum Reserve to increase the supply in spot markets. To support growth and employment, Wray calls for debt relief for burdened homeowners and indebted households, as well as a substantial federal effort to rebuild and expand the nation's neglected infrastructure—with a substantial portion of the spending directed toward public transportation, thereby furthering oil conservation efforts. Increasing such spending would target a sector that is now suffering, he says, while at the same time increasing America's productive capacity and improving living standards. With needs estimated at nearly $2 trillion, Wray says, this sector alone "could generate enough jobs and consumer demand to keep the economy close to full employment for the next decade."

Even if a deep depression and debt deflation can be avoided, Wray contends that the biggest policy challenge will be to address the risky financial practices that caused the current crisis. While Wray says we cannot and should not go back to New Deal–era practices, he calls for thorough reform, to "make it more difficult for regulated and protected banks and thrifts to participate in the next speculative boom—or to contribute to the next collapse." To conclude, Wray argues that "appropriate fiscal stimulus—oriented toward job creation and restoration of public infrastructure, a rescue plan for homeowners, elimination of cheap dollar/mercantilist policy, and removal of government-supported managed money from commodities markets—will provide an effective remedy for what ails the U.S. economy today." In his view, the "Big Bank" Fed cannot do much more than it has already done; the rest is up to what the late economist Hyman P. Minsky called "Big Government" policy operating in the public interest. "The proper role for government has been neglected for too long," Wray writes. "Hopefully, the 'hands-off' worship of the 'free markets' era has run its course and sensible policy formation will enjoy a resurgence."

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<u>Policy Note 2008/3: *What's a Central Bank to Do? Policy Response to the Current Crisis*</u>

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