

# Negative Implications of the Unconventional Monetary Policies in the Advanced Economies: Time for an Orderly Exit

**Shalendra D. Sharma, Ph.D**

Professor of Political Science University of San Francisco

## Negative Implications of the Unconventional Monetary Policies in the Advanced Economies: Time for an Orderly Exit

Central banks in the United States, Japan, Great Britain and in the Eurozone have deployed new policy tools labeled “unconventional monetary policies” both during and after the global financial crisis of 2008. These policies were designed to (a) prevent a collapse of the financial system by stabilizing financial markets via massive injection of cash into the system through direct liquidity provision and purchases of private assets, and (b) to provide monetary policy assistance through bond purchases to keep interest rates at zero or near zero. Clearly, these policies have helped support economic recovery. Nevertheless, these unconventional measures also carry potentially unintended risks. Therefore, a timely and orderly exit from these easy monetary conditions is essential.

JEL classification: C32, E30, E44, E51, E52

**Keywords:** unconventional monetary policy, zero lower bound, sovereign debt, central bank, Japan

Both during and in the aftermath of the global financial crisis of 2008 central banks in advanced economies were forced to adopt unconventional monetary policies to counter the risks to their financial systems and reboot economic growth. This is because with policy rates already near zero, advanced country central banks had little choice but to turn to these unconventional monetary policies to stimulate growth. These measures included direct lending to distressed short-term credit markets, expanding bank reserves and via the purchase of long-term assets to reduce long-term interest rates.

In the United States, with the Federal Reserve’s (for the Fed) main policy tool, the federal funds rate at “zero lower bound” on nominal interest rates since December 2008, the Fed could no longer lower interest rates to boost investment and consumption. Hence the use of “Quantitative Easing” (QE) which allowed the central bank to literally flood the banking system with excess reserves in the hopes that the banks would begin to lend, and, in the process jump-start economic growth. This policy option also allowed the Federal Reserve to engage indirectly in real exchange rate depreciation through “large-scale asset purchases” (LSAPs) or Quantitative Easing. To this effect, the U.S. Federal Reserve has literally created large volumes of money to purchase equally large quantities of bonds from the financial markets to boost economic activity. Again there are costs: From November 2008 through March 2010, Quantitative Easing 1 (QE1) bought \$1.75 trillion in long-term Treasuries as well as debt

issued by Fannie Mae and Freddie Mac and fixed-rate mortgage-backed securities (MBS) guaranteed by those agencies. In other words, it purchased mostly bad mortgage debt. From November 2010 through June 2011, Quantitative Easing 2 (QE2) bought \$600 billion of U.S. government debt in the form of long-term Treasuries. In June 2012 the Federal Reserve's "Open Market Committee" voted to extend "Operation Twist" or its program of selling short-term Treasury securities and purchasing long-term Treasuries through the end of 2012. Altogether, the Fed plans to sell some \$667 billion in short-term bonds and purchase roughly the same amount of Treasuries with maturities ranging from six to thirty years. In September 2012 the Open Market Committee announced QE3 to begin purchasing \$40 billion in agency-backed MBS per month until economic condition improved, including maintaining its previous program of exchanging about \$45 billion monthly in short-for long-term securities. Overall, between August 2008 to end-2012, the Federal Reserve has tripled the monetary base from roughly \$0.8 trillion to \$2.9 trillion.

While QE1 and QE2 involved the purchase of specific types of securities within a defined time period, QE3 has no limits -- meaning the Fed can buy unlimited amounts of mortgages, Treasuries or other securities indefinitely or for as long as it sees fit. Overall, the Fed's LSAPs have resulted in a dramatic expansion of the central bank's balance sheet and the monetary base. Clearly, the current position is not sustainable and carries huge negative implications for the economy. Specifically, since the Federal Reserve is the sole buyer propping the U.S. bond prices, when the Fed eventually sells or "unwinds" its asset-purchase programs it could drive down prices and sustain huge losses. After all, the purchase of potentially worthless MBS is akin to transferring the financial liabilities of the banks on to taxpayers. Furthermore, these potential losses do not include the Federal government's massive interest payment obligations. Markets know well that in the end, one sure time-tested way to recoup these losses is through higher taxation.

The U.S. Federal Reserve's monetary activism has pushed (if not forced) other advanced economy central banks to also rely increasingly on quantitative easing measures, besides requiring their banks to buy up their own government's debt by implicitly allowing banks not to count the sovereign debt against their Basel capital requirements. For example, the European Central Bank (ECB) has implemented three asset purchase programs since 2011 providing more than €1 trillion in low-cost financing to Eurozone banks. On 6 September 2012 the ECB introduced its ambitious program of "Outright Monetary Transactions" (OMT) which allows the Central Bank to purchase Eurozone sovereign debt in the secondary market provided the sovereign follows strict conditions (ECB 2012). Between March 2009 and January 2010, the Bank of England (BOE) purchased some £200 billion of assets -- mostly U.K. government debt securities or *gilts* -- harking back to the time when the edges of the paper bonds were golden or "gilded." On 6 October 2011 the BOE increased the QE target from £200 billion to £275 billion and on 9 February 2012 to £325 billion. On 5 July 2012 the BOE increased the QE target again to £375 billion. Cumulatively, the BOE's QE program has almost quadrupled the country's monetary base (Breedon et al., 2012; Joyce et al., 2011).

The 16 December 2012 election of Shinzo Abe as Japan's Prime Minister signaled that the world's third largest economy would also be aggressively pursuing accommodative monetary policy. Abe, who has long blamed the yen's appreciation on the easy monetary policies of the United States (and to a lesser extent on the Eurozone) responded boldly to this so-called "unfair practice." Prime Minister Abe's policies dubbed "Abenomics" has admittedly "three arrows" designed to jolt the moribund Japanese economy. These include massive fiscal stimulus, aggressive monetary policy and improved competitiveness of the Japanese economy. Cognizant that the third arrow or improved competitiveness will require broad structural reforms and will take time, Abe instructed the Bank of Japan (BOJ) to ease up on monetary policy by doubling its inflation objective and expanding its asset purchase program.

More bluntly, Abe demanded that the BOJ to pursue a quantitative-easing strategy in order to deliver inflation rate of 2-3 percent and weaken the yen.

No doubt, with its benchmark interest rate already close to zero Japan's central bank has little choice but to engage in the purchase of government bonds to inject liquidity into the economy and hopefully push Japan out of its pervasive deflationary stagnation (Ueda 2012). In April 2012 the BOJ announced the purchase of \$61 billion of assets to inject more liquidity in the economy, besides maintaining interest rates between zero and 0.1 percent. In September 2012 the BOJ added \$128 billion more to its program of asset purchases, and in December 2012 increased its quantitative easing program by another ¥10 trillion (\$118 billion). By year-end 2012, the BOJ's easing program had pumped an estimated \$1.2 trillion (¥101 trillion) in the Japanese economy. Yet, this still was deemed insufficient. In early-January 2013, Tokyo approved an "emergency" stimulus of ¥10.3 trillion (\$116 billion) to create demand and to further boost the moribund economy, and on January 22, the BOJ set a 2 percent inflation target and agreed to open-ended asset purchases. On 4 April 2013, the BOJ's new Governor Haruhiko Kuroda announced the central bank's most ambitious move yet: its decision to buy ¥50 trillion (\$520 billion) in government bonds per year with maturities of up to 40 years, including some ¥30 billion (\$323 million) of Japanese real estate investment trusts and ¥1 trillion (\$10.5 billion) of exchange traded funds annually. This means that by the end of 2014, the BOJ's actions would double the monetary base of the country.

### **Unintended Economic Consequences**

Despite the claim that the BOJ's aggressive action is designed stimulate growth by breaking the debilitating spiral of deflation that has gripped the Japanese economy for the past two decades there are also potential unintended consequences. Cumulatively, the BOJ's actions will mean an expansion of the monetary base totaling about 10% of Japan's GDP. Yet, with Japan's gross government debt-to-GDP ratio at an estimated 209 percent of GDP at end-2012 (the largest in the OECD) such loose monetary policy has the real potential to trigger the build-up of asset bubbles – similar to what happened in the late 1980s. It could also trigger inflation (making it more costly for Japan to finance its large volume of government deb) and weaken the yen. Even as a weak yen will make Japanese exports more competitive vis-à-vis that of Chinese and South Korean exports, it could potentially lead to competitive devaluations in the region, if not outright currency war as countries devalue their currencies. Over the longer term, Japan's stagnant economic growth, its deflationary environment and negative demographics (namely, shrinking workforce), will make growing out of the debt difficult.

Although, the U.S. Federal Reserve has long claimed that its rationale for injecting liquidity in the economy and maintaining low interest rates is aimed at encouraging investment and job growth (or the BOJ claims that its central goal is to stem the persistent deflation -- and there is no reason not to believe either's justification), one of the consequences of the Fed's actions is that it also pushes down the value of the dollar just as the BOJ's aggressive actions further devalues the yen. In the end, the worsening of the competitive position of other major currencies could very well force a new round of competitive devaluations as countries weaken their currencies to boost exports. Not surprisingly, emerging economies like China, Brazil, India and other G-20 member-states have concluded that the advanced economies, in particular, the U.S. government's aggressive bond-buying measures is designed not only to give U.S. exporters an unfair advantage by driving down the value of the dollar, but also that a stronger U.S. dollar would undermine their exports. Emerging economies are particularly concerned that the Fed's Treasury bonds purchase would push Treasury interest yields so low that it could potentially force investors to pump massive volumes of speculative capital (or "hot money") in the form of capital,

portfolio equity, fixed-income investments and stocks into emerging markets. If this were to happen on a large enough scale it would negatively impact these economies, exacerbating exchange rate volatility and sharply “shoot-up” their currencies (and thereby undermining their exports), besides creating dangerous asset bubbles (Chen et al., 2012). Countering these negatives could very well force a new round of competitive devaluations as countries weaken their currencies to boost exports.

Justifiably, emerging economies remain deeply concerned about their ability to respond to inflows which will inevitably drive up their exchange rates and threaten their export base. Over time, it could also potentially trigger inflationary pressures and create bubbles in their economy (especially real estate), besides making the economy’s stability contingent on the sentiments of foreign investors (Chung et al., 2012; Glick and Leduc 2012). Indeed, many of the emerging G-20 economies have every reason to be concerned about the rising levels of public debt in the United States. They also know that the United States aggressive monetary easing vividly illustrated by Washington’s willingness to print new money (to cover its deficits and hide the real value of its debt) is laying the foundations for inflationary pressures, both nationally and globally. This explains why a number of countries, including Brazil, China, India, Indonesia, South Africa, Japan, Malaysia, Taiwan and Thailand, among others, have recently put in place capital controls on foreign investments in their bond markets to curb currency appreciation. For example, Brazil deeply concerned that foreign investors were pushing-up the prices of securities has limited capital inflows by taxing investors’ purchase of the country’s stocks and bonds. Brazilian authorities are also concerned that massive influx of foreign capital would inflate the value of its currency, the *real* (in fact, Brazil’s flexible exchange rate was fast rising against both the dollar and the euro) making Brazilian exports uncompetitive and dampening the country’s economic growth. It is not unreasonable to suggest that this growing discord and acrimony between leading G-20 countries has the potential to unleash a destructive currency and trade war.

Indeed, during their mid-February 2013 meeting, the G-20 finance ministers and central bankers once again reaffirmed their pledge to “refrain from competitive devaluation,” besides going to great lengths to downplay concerns that the actions of some were weakening the value of their currencies. However, there is no getting away from one of the side-effects of monetary easing: that it also weakens a country’s currency. To markets, actions talk louder than deeds. For example, it is hard to miss the reality is that since Abe’s election and the BOJ’s aggressive monetary policy the yen has depreciated by 8.7 percent against the dollar to ¥/\$ 86.7 during the second half of 2012, and depreciated by an additional 12.5 percent to ¥/\$ 97.6 by early April 2013. As the yen has depreciated, the dollar and the euro has appreciated -- and talk of “currency war” palpable. Whether the G-20 has the ability to bring their members exchange rate into alignment or if these actions signal further spiral towards beggar-thy-neighbor policies is an open question.

### **Exiting Unconventional Monetary Policies to Reduce Debt**

Sovereign debt (or debt that is issued or guaranteed by a “sovereign” or government) in the advanced economies has increased exponentially in the aftermath of the 2008 global financial crisis. The compendium of large fiscal stimulus packages, bailouts of the financial sector, the nationalization of private sector debt, reduced tax revenues due to the contraction in economic activity, the prolonged recession and anemic recovery have worsened debt-to-GDP to levels not seen since the Great Depression of the 1930s. Table 1 highlights the problem in the EU.

**Table 1: Gross National Debt in selected EU countries, 2010 (in U.S. dollars)**

<u>Country</u>	<u>Debt</u>	<u>% of GDP</u>
Germany	3.0 trillion	83.2
Italy	2.6 trillion	119.0
France	2.3 trillion	81.7
United Kingdom	1.9 trillion	80.0
Spain	908.4 billion	60.1
Greece	467.3 billion	142.8
Portugal	228.2 billion	93.0
Ireland	210.6 billion	96.2
Belgium	485.0 billion	96.8
Austria	291.8 billion	72.3
Netherlands	527.7 billion	62.7
Finland	124.0 billion	48.4
Poland	228.2 billion	93.0
Sweden	208.2 billion	39.8
Denmark	145.2 billion	43.6
Hungary	111.3 billion	80.2
Latvia	11.4 billion	44.7
Estonia	1.4 billion	6.6

*Source:* compiled from Eurostat.com

In 2010, the advanced economies averaged a budget deficit of about 8.3 percent and were burdened with a public debt-to-GDP ratio of 97 percent – a sharp increase from about 75 percent in 2006 (IMF 2010). By end-2012, OECD government debt-to-GDP reached 105.7 percent (OECD 2012). More specifically, in the Eurozone, the governments of Greece, Ireland and Portugal together owe roughly €650 billion (roughly \$1 trillion). Spain alone owes more than €640 billion while Italy and France each owe more than €1.8 trillion. Cumulatively, the EU's debt totals about €11 trillion (European Commission 2013) -- and this does not include the massive unfunded liabilities of the union's generous welfare benefits, including pensions and health care. Japan's debt is even higher totaling some 230 percent of GDP (Greece's debt is at 175 percent of GDP), and the annual budget deficit is nearly 10 percent of GDP -- higher than all the Eurozone countries (Ueda 2012).

The case of the United States, the world's biggest borrower and largest debtor further underscores the gravity of the problem. In December 2000, U.S. national debt (or the sum of all outstanding debt owed by the Federal Government) stood at \$5.66 trillion. In December 2008 the debt stood at \$10.7 trillion, and in March 2010 the gross national debt was over \$13 trillion. As of December 2012, U.S. national debt stood at just around \$16.2 trillion. Nearly two-thirds is public debt (which is owed to the people, businesses and foreign governments who purchased Treasury bills, notes and bonds), while the remaining one-third or "intra-governmental holdings" stood at \$4.74 trillion. As of July 2012, some \$5.3 trillion or about 48 percent of debt held by the public was owned by foreigners -- with China and Japan holding some \$1.1 trillion each. This already crushing debt levels does not include the state and local government debt in the United States, which at the end of the first quarter of 2010 stood at \$2.8 trillion in outstanding debt (CRS 2011; GAO 2012). According to the non-partisan Congressional Budget Office (CBO 2012), if the current trajectory is not reversed, by 2020, the annual interest owed on U.S.

debt will approach \$1 trillion or roughly 21 percent of projected federal revenue for that year. What is not well known is that this estimate is based on optimistic projections. The reality is that much of the post-crisis debt is issued short-term (in 3 to 6 month durations) to take advantage of the low short-term interest rates. This also means that the Treasury must frequently and regularly refinance its debt. Of course, this debt burden could literally explode when interest rates start to creep up.

This already crushing debt levels does not include the state and local government debt in the United States, which at the end of the first quarter of 2010 stood at \$2.8 trillion in outstanding debt (CRS 2011; GAO 2012). Defaults by a number of cities underscore the fiscal woes. In June 2012, the city of Stockton (California), filed for Chapter 9 bankruptcy as it could not meet its \$700 million in financial liabilities. This was followed in August 2012 by San Bernardino (California), which filed for bankruptcy protection largely because its employee retirement costs in 2012 were double the 2006-2007 values. More ominous, on 18 July 2013, Michigan's largest city, Detroit, filed for bankruptcy making Detroit the largest U.S. city to seek bankruptcy protection.<sup>1</sup> Although, Chapter 9 of the U.S. Bankruptcy Code gives Detroit protection by allowing the city to stop making payments on some of its debts, including temporary protection from lawsuits, the harsh reality is that the depressed and dilapidated city is flat broke and in no position to service its estimated \$18 billion debt. The root of Detroit problems – owing billions of dollars in unfunded pension and health care liabilities – is not unique.<sup>2</sup> Rather, municipalities throughout the United States are burdened with similar debt with no easy way of meeting their obligations without painful restructuring of debts and steep tax increases. That is, there is no consensus on how to resolve the problem of exploding expenditures with shrinking revenues. The realization that even a major metropolis like Detroit is not “too big to fail” raised fears of a wider default risk -- sending shock waves in the markets. This explains why following Detroit announcement, Chicago saw its credit rating downgraded because of concerns regarding its \$19 billion unfunded pension liability -- which according to Moody's is actually around \$36 billion.

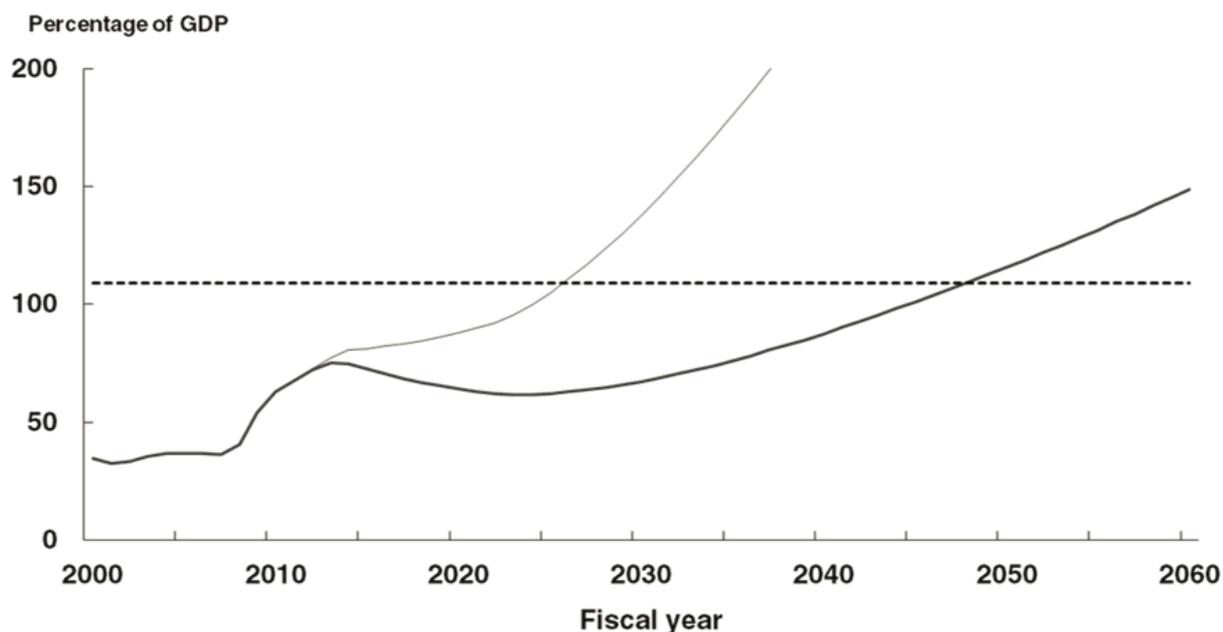
Like their government and cities, many American households debt burden (or their ratio of debt payments to disposable income) have grown steadily. This is because households have saved too little and spend too much relative to their income. As of September 2012 “household debt” (which families owe on home, auto, student loans, credit cards and other types of consumer debt) stood at a whopping \$11.31 trillion. Again, this already grave state of affairs is not counting the ballooning “unfunded” public sector pension and retiree health benefit liabilities as such Medicare and Medicaid (an outstanding liability is not covered by an asset of greater or equal value). These obligations would add further tens of trillions of dollars in additional debt (CBO 2012a).

---

<sup>1</sup> Detroit's bankruptcy became inevitable when an out-of-court restructuring effort failed. Only a handful of creditors agreed to accept a plan offered by the city's “Emergency Manager” Kevyn Orr to cover the \$11.5 billion in unsecured debt with \$2 billion cash offer.

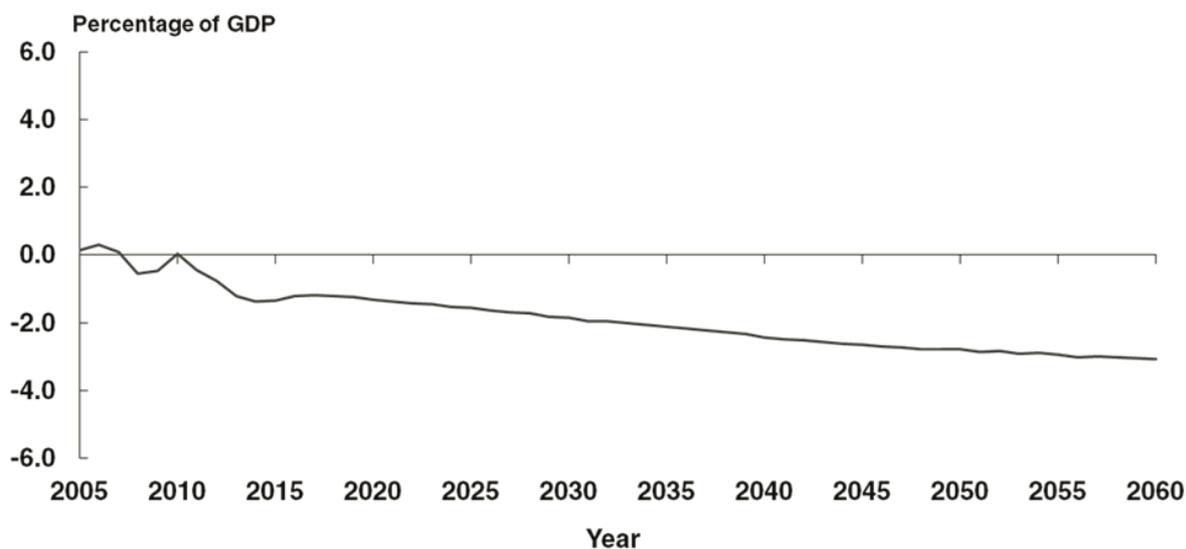
<sup>2</sup> It is estimated that Detroit owes some \$5.7 billion in retiree health costs and about \$3.5 billion in pensions.

**Chart 1: Federal Debt Held by the Public under Two Fiscal Policy Simulations**



Source: GAO (2012) <http://www.gao.gov>

**Chart 2: State and Local Governments Fiscal Challenges**



Source (GAO 2011) <http://www.gao.gov>

Reinhart and Rogoff (2009) point out that when a nation’s gross debt reaches 90 percent of its economy it usually loses about one percentage point of growth a year.<sup>3</sup> In the United States, including

3 Reinhart and Rogoff’s claim (that growth rate slows down sharply when the debt-to-GDP ratio of a country rises above 90 percent) was recently found to contain an error. Namely, coding errors by the authors resulted in the exclusion of some countries from the dataset -- leading to skewed averages. New calculations showed that even if the debt load increased beyond the 90 percent threshold, growth still occurred. Regardless, it is important to note that the Reinhart-Rogoff study is just a small part of a very large body of scholarship that confirms that high debt/GDP ratios impede growth. Of course, a much larger debate regarding causality remains unresolved. That is, does high debt causes lower growth, or does debt increase because of slowdown in economic growth, and what is the specific threshold at which debt dynamics begins to undermine growth?

many other advanced economies, the gross debt is either very close or already over this threshold. The U.S. debt has already surpassed 100 percent of GDP – three years before the IMF’s (2011) projection that U.S. national debt will reach 100 percent of GDP by 2015. This means that the United States will need to reduce its deficit by the equivalent of 12 percent of GDP. On the other hand, Greece, in the midst of a financial crisis in 2008, needed to reduce its structural deficit by just 9 percent of GDP. Moreover, the oft-noted counter-argument that Japan’s outstanding debt (in absolute terms and relative to GDP) is much larger than that of the United States should provide little comfort. Not only a very large percentage of Japan’s debt is held domestically, Japan (unlike the United States) also has a high savings rate. This partly explains why the United States rapidly ballooning debt levels have generated greater concern forcing credit rating agencies like Standard & Poor to downgrade U.S credit rating from AAA to AA+ on 5 August 2011.

However, as discussed, rather than dealing with this problem head-on, governments in the advanced economies have been engaging with “stealth” tactics under the guise of unconventional monetary policies to reduce their debt burdens. Clearly, this is not sustainable over the long term. As Reinhart and Rogoff (2009) warn, the nature of debt crisis is that it results in self-fulfilling prophecies. That is, the debt cannot grow indefinitely because markets will eventually began questioning a sovereign’s ability to meet its obligations. A loss of confidence in the sovereign’s ability to pay would result in higher borrowing rates, and an increase in the cost of debt service. Moreover, they point out that about half of the sovereign bankruptcies in the period 1970 to 2008 involved countries with a debt to GDP ratio of 50 percent or less. However, in 2012, advanced economies with debt ratios of more than 100 percent include the United States and Japan (although Japan is a special case as it owes more than 90 percent of its national debt to its own citizens) with many others with debt ratios of over 50 percent. The claim that foreign creditors will not abandon the U.S. anytime soon (like they have done to the peripheral Eurozone countries) is becoming less compelling. Increasingly, foreign holders of U.S. debt are diversifying their investments. Indeed, the rising prices on credit-default swaps (CDSs) on U.S. debt (which has risen from less than 5 points per annum in 2007 to more than 40 points by March 2011) underscore that financial markets increasingly are worried about the United States financial health – even if they do not fear an imminent default. Over time, diminishing demand for U.S. Treasuries could increase interest rates, and in the process, negatively impact economic recovery and growth.

### **The Task at Hand**

To break this vicious debt cycle (where the banking sector needs to recapitalize, the sovereign carry-out fiscal consolidation and households and firms sharply reduce their debt levels), authorities must have in place a credible deficit and debt reduction plan to spur growth. In the case of the United States where the deficit is largely the result of sharp increases in expenditures relative to GDP, credible commitment to cut government spending and related fiscal consolidation strategies can help reduce debt levels and generate investor confidence. Put bluntly, as skyrocketing debt is mainly the result of continuous government borrowing to pay for current consumption, fixing the dismal state of public finances in the United States and many other advanced economies will require wide-ranging and deep fiscal consolidation with determined focus on cutting public spending, including the drivers of future spending. Once this is done in a meaningful way, reform of the country’s convoluted taxing system can begin.

Indeed, according to an IMF report (Jonas and Sancak 2011), when governments reduce their deficits by cutting spending they experience short-lived recessions. However, when governments reduce deficits by raising taxes they are very likely to experience deeper and longer recessions. Moreover,

raising taxes on the “wealthy” to reduce deficits – while good populist rhetoric – will simply not generate enough revenues. According to the White House Office of Management and Budget, taxing income over \$250,000 will raise a mere \$56 billion a year or less than 5 percent of a \$1 trillion dollar deficit. Similarly, under President Obama’s preferred plan to let the top two income tax rates revert to 39.6 percent and 36 percent (from the current 35 percent and 33 percent), including increase in the capital gains and dividend rates from the current 15 percent to 20 percent (for individuals earning \$200,000 and couples \$250,000 and more) will only reduce the deficit by about \$1 trillion over 10 years. The oft-repeated argument for more taxation: (a) that the U.S. tax system has become less progressive as the largest tax cuts have gone to high-income earners, and (b), that the United States has a much lower tax-to-GDP ratio (approximately 18 percent), while the tax-to-GDP in most advanced or OECD economies is roughly 30 percent is disingenuous as currently an estimated 50 percent of American households do not pay taxes (either because they earned income is below the taxable threshold or through credits and deductions), while less than 5 percent of American taxpayers already pay a disproportionate 50 percent of the total tax revenues. Not only increases in the marginal tax rates negatively effects savings, employment and investment, imposing more punitive taxes on this small group is hardly a long-term solution. To the contrary, it is detrimental to economic innovation and growth – and we all know that a growing economy is the best way to reduce the debt burden. Finally, the lawmakers’ populist penchant to always focus on cutting federal discretionary spending such as foreign aid or to public broadcasting is a *non-sequitur* – a way to avoid the real problem -- as these programs are so miniscule that eliminating them will hardly make a dent in the overall debt and deficits.

The reality is that the United States (and many other advanced economies) cannot resolve their exploding debt problems without both revenue increases and spending cuts. This means slowing the growth in entitlement spending and tax increases by broadening of the tax base and closing the many “loopholes” by reducing the numerous “exemptions,” “deductions,” and “credits.” Admittedly, for this to happen, the American people must accept the harsh reality that their country suffers from both a spending and a revenue problem. That is, on one hand, the government spending is out of control, on the other, there is not enough revenue to pay for all the benefits and services the public wants. Indeed, President Obama’s “Presidential Commission on Fiscal Responsibility and Reform” co-chaired by former Republican Senator Alan Simpson and President Clinton’s former Chief of Staff Erskine Bowles in November 2010 released a proposal that attempted to bridge this disconnect.

The proposal recommended among other things, (a) \$200 billion reduction per year in discretionary spending, (b) \$100 billion in increased tax revenues with a 15 cent per gallon gasoline tax and the cancelation of tax deductions like the home mortgage interest deduction, (c) maintain the Obamacare Medicare cost controls with a possible public option for health care reform, (d) raise in the retirement age for Social Security, including a raise the payroll tax, and cuts to the corporate tax rate from 35 percent to 26 percent. Indeed, the Simpson-Bowles proposal to reduce the large and regressive tax expenditures such as preferential tax rates for capital gains and dividends and deductions for state and local taxes with progressive tax credits have the potential to generate enough revenue to eventually reduce rate for all taxpayers. Unfortunately, these proposals never received a fair hearing and were rejected by members of both parties. This is like throwing the baby with the bathwater. The Simpson-Bowles proposals provide a working document to which both parties must return to curb the United States addiction to fiscal profligacy. Failure to make these hard choices will eventually force the market to dispense its own correction. If history is any guide this alternative will be far more wrenching.

### Sources:

- Autor, David. 2010. "The Polarization of Job Opportunities in the U.S. Labor Market." *The Hamilton Project and The Center for American Progress*, April, pp. 1-40.
- Breedon, F., J. S. Chadha and A. Waters. 2012. "The Financial Market Impact of U.K. Quantitative Easing." *Oxford Review of Economic Policy*, vol. 28, no. 4, pp. 702–28
- CBO (Congressional Budget Office). 2012. *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*. August, Congressional Budget Office: Washington, D.C.
- , 2012a. "The 2012 Long-Term Budget Outlook," Washington: Government Printing Office. [www.cbo.gov/sites/default/files/cbofiles/attachments/06-05LongTerm\\_Budget\\_Outlook\\_2.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/06-05LongTerm_Budget_Outlook_2.pdf)
- , 2010. *The Budgetary Impact and Subsidy Costs of the Federal Reserve's Actions during the Financial Crisis*. May. Congressional Budget Office: Washington, D.C.
- Chen, H., V. Cúrdia and A. Ferrero. 2012. "The Macroeconomic Effects of Large - Scale Asset Purchase Programmes." *The Economic Journal*, vol. 122, no. 564, pp. F289–F315.
- Chung, H., J.-P.Laforte, D. Reifschneider and J. C. Williams. 2012. "Have We Underestimated the Likelihood and Severity of Zero Lower Bound Events?" *Journal of Money, Credit and Banking*, vol. 44, no.1, pp. 47–82
- CRS (Congressional Research Service). 2011: 14 April. *State and Local Government Debt: An Analysis*. CRS Report R41735 by Steven Maguire.
- Eichengreen, Barry. 2011. *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System*. New York: Oxford University Press.
- Eichengreen, Barry, Donghyun Park and Kwanho Shin, 2011. "When Fast Growing Economies Slow Down: International Evidence and Implications for China," March, NBER Working Paper No. w16919. Available at SSRN: <http://ssrn.com/abstract=1801089>
- European Central Bank (ECB). 2012. "Impact of the Two Three-Year Longer-Term Refinancing Operations." European Central Bank, *Monthly Bulletin*, December, pp. 37-39.
- European Commission. 2013. "Euro Area and EU27 Government Debt Nearly Stable at 90.0% and 85.1% of GDP Respectively." *Eurostat*, News Release Euro Indicators (23 January). available at [http://epp.eurostat.ec.europa.eu/cache/ITY\\_PUBLIC/2-23012013-AP/EN/2-23012013-AP-EN.PDF](http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-23012013-AP/EN/2-23012013-AP-EN.PDF)
- Friedberg, Aaron. 2012. "Bucking Beijing," *Foreign Affairs*, vol. 91, no. 5, September /October, pp. 48-58
- GAO (U.S. Government Accountability Office). 2012. "State and Local Governments' Fiscal Outlook: April 2012 Update." Available at [www.gao.gov/assets/590/589908.pdf](http://www.gao.gov/assets/590/589908.pdf)
- Glick, R. and S. Leduc. 2012. "Central Bank Announcements of Asset Purchases and the Impact on Global Financial and Commodity Markets." *Journal of International Money and Finance*, vol. 31, no. 8, pp. 2078–101.
- IMF. 2011. "The United States: 2011 Article V Consultation." IMF Country Report No. 11/201. July, Washington, D.C.: International Monetary Fund.
- , 2010. *World Economic Outlook: Recovery, Risk and Rebalancing*. October, Washington, D.C.: IMF.
- Jaimovich, Nir and Henry Siu. 2012. "The Trend Is the Cycle: Job Polarization and Jobless Recoveries." NBER Working Paper No. 18334, *National Bureau of Economic Research*, August, pp. 1-36.
- Jonas, Jiri and CemileSancak. 2011. "Fiscal Neighbors," *Finance & Development*, September, vol. 48, No. 3, pp. 30-33.
- Joyce, M., M. Tong and R. Woods. 2011. "The United Kingdom's Quantitative Easing Policy: Design, Operation and Impact." Bank of England, *Quarterly Bulletin*, Q3, pp. 200–12.

- Kirshner, Jonathan. ed., 2003. *Monetary Orders: Ambiguous Economics, Ubiquitous Politics*. Ithaca, N.Y.: Cornell University Press.
- , 1997. *Currency and Coercion: The Political Economy of International Monetary Power*. Princeton, N.J.: Princeton University Press.
- Kotlikoff, Laurence and Scott Burns. 2012. *The Clash of Generations: Saving Ourselves, Our Kids, and Our Economy*. Cambridge, MA: MIT Press.
- Krugman, Paul. 2012. "Nobody Understands Debt," *The New York Times*, January 1.  
<http://www.nytimes.com/2012/01/02/opinion/krugman-nobody-understands-debt.html?pagewanted=print>
- Lund, Susan and Charles Roxburgh. 2010. "Debt and Deleveraging: The Global Credit Bubble and its Economic Consequences," *World Economics*, vol. 11, no. 2, April–June, pp. 1-30
- McKinnon, Ronald. 1973. *Money and Capital in Economic Development*, Washington, DC: Brookings Institute.
- OECD (Organization for Economic Co-Operation and Development). 2012. *OECD Sovereign Borrowing Outlook 2012*, Paris: OECD Publishing
- Reinhart, Carmen and M. Belen Sbrancia. 2011. "The Liquidation of Government Debt," NBER Working Paper 16893, Cambridge, Massachusetts: National Bureau of Economic Research, March.
- Reinhart, Carmen and Kenneth Rogoff. 2009. *This Time is Different: Eight Centuries of Financial Folly*. Princeton, NJ: Princeton University Press.
- Spence, Michael. 2011. *The Next Convergence: The Future of Economic Growth in a Multispeed World*. New York: Farrar Straus Giroux.
- Thomas, Jason. 2010. "Managing the Federal Debt," *National Affairs*, No. 5, Fall, pp. 20-34.
- Tomz, Michael. 2007. *Reputation and International Cooperation: Sovereign Debt Across Three Centuries*. Princeton, NJ.: Princeton University Press.
- Ueda, K. 2012. "The Effectiveness of Non-Traditional Monetary Policy Measures: The Case of the Bank of Japan." *Japanese Economic Review*, vol. 63, no. 1, pp. 1–22.