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Markets and Economy

Fiscal policy likely to take center stage with Yellen at Treasury

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Boston - The appointment of Janet Yellen as Treasury secretary by President-elect Joe Biden marks a milestone in what I believe has been a major trend since the 2008 global financial crisis: the blurring of monetary and fiscal policy.

Yellen, of course, was U.S. Federal Reserve Chair Jay Powell's immediate predecessor, and in my view, an excellent choice for Treasury secretary. Her experience within the Federal Reserve System also includes stints as Vice Chair of the Board of Governors and President of the San Francisco Fed.

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For some context, it's useful to recall that central bank independence has been a relatively recent development. Going back hundreds of years, central banks typically were created to help governments fund wars or empire-building. While the Fed was created in 1913, it didn't have an independent monetary policy until the Treasury-Fed accord of 1951. Before then, the Fed was actively involved in financing U.S. efforts in both World Wars, and kept Treasury rates pegged at acceptable levels through its purchases in peacetime.

Central bank independence is usually associated with politically unpopular decisions to tighten monetary policy in fighting inflation or as a counterweight to government spending, particularly before an election. This was common from the late 1970s through the 1990s in a number of countries.

Blurring fiscal and monetary policies

The dynamic is different in times of economic crisis, however, as policymakers on both fiscal and monetary sides work together — there is a natural blurring of efforts to mitigate the damage. For example, programs enacted by Congress and administered by the Treasury and the Fed were key to the recovery efforts after 2008 and also last March during the height of the COVID-19 market turbulence.

As a classical Chicago-trained economist, I believe a distinct line between fiscal and monetary policy is valuable, and has proven its worth over the years. But politically, the blurring of the lines is inevitable. Another clear sign of this is that Fed Governor Lael Brainard was reported to be the number two pick for Treasury secretary, and has been rumored as a possible successor to Fed Chair Powell if he is not reappointed in 2022.

I think it's reasonable to anticipate that fairly aggressive fiscal policy would be pursued by a Yellen Treasury. Monetary tools are having diminished impact, with interest rates at all-time lows and the Fed's balance sheet swollen to an unprecedented degree. Also, monetary stimulus powered market assets to record heights without doing much to help the real economy, and one result was worsening wealth inequality. Yellen is in an excellent position to devise appropriate fiscal policy to address that, especially given her expertise and philosophical background.

With so much slack in the economy, I expect the near-term inflationary impact of greater fiscal stimulus to be minimal, but it could pose a problem when growth nears capacity constraints. Along those lines, it's also worth keeping an eye on the debate over Modern Monetary Theory (MMT), which essentially holds that governments can run deficits as high as needed without costs, as long as inflation isn't extremely high or low at the time.

Economist Stephanie Kelton, an adviser to the Bernie Sanders campaign, is one of MMT's chief proponents. I believe it's a mistake to dismiss the long-run potential harm of ever-increasing deficits — theywill grow large enough even without the support of a theory that contends they pose no threat.

Bottom line: Fiscal policy is likely to grow in importance during Yellen's tenure as Treasury secretary, with the potential to provide more effective stimulus than monetary policy, while helping to reduce wealth inequality.