February 02, 2016

WELLS FARGO SECURITIES

Economics Group

Special Commentary

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The Intersection of Fiscal and Monetary Policy

Executive Summary

Congressional action and proposed legislation over the past year have brought to light the intersection of fiscal and monetary policy. While lawmakers maintain the responsibility for charting the country's fiscal course, the Federal Reserve, for the most part, manages monetary policy independently of the political process. In the recently passed highway bill, Congress paid for spending, in part, by transferring a sizable segment of the Federal Reserve's capital surplus account to the U.S. Treasury. This recent action is just one example of Congress using a tool of monetary policy to assist fiscal policy. Even beyond the highway bill, there have been several bills and proposals to bridge the distance between fiscal and monetary policy. The proposals have ranged from having the Government Accountability Office perform an audit of the Federal Open Market Committee's (FOMC) interest rate decisions to a bill passed by the House of Representatives that would require the FOMC to abide by a rule to set interest rates and restrict the emergency lending powers of the Fed. While we refrain from commenting on specific bills or proposed legislation, we do think it is important to understand the ways in which fiscal and monetary policy have interacted recently, how they might interact in the future, and the importance of fiscal and monetary policy independence.

In this report, we review how U.S. fiscal and monetary policy interact and provide insight into how the current ongoing process of monetary policy normalization could affect the fiscal policy outlook over the next several years. We conclude with a review of the academic literature providing evidence of the importance of central bank independence.

How Do Fiscal and Monetary Policy Interact?

Since the establishment of the Federal Reserve in 1913, the U.S. Federal Reserve has mostly maintained its independence from the political process. That said, the chairman of the Federal Reserve Board is appointed by the president of the United States and the Federal Reserve itself is subject to Congressional oversight. This oversight activity includes requiring the Federal Reserve Board of Governors and staff to testify before Congress, along with Government Accountability Office (GAO) reviews and audits of the Federal Reserve's activities. For the most part, the GAO has the ability to audit several aspects of the Fed with the only statutory restriction that prevents the GAO from evaluating the merits of Fed policy decisions.[1] Beyond the political appointees and oversight, there is one other important aspect of the relationship between fiscal and monetary policy. The Fed can affect the federal budget through its monetary policy actions, which can influence net interest costs and remittances to the Treasury. The Federal Reserve is required to remit excess earnings to the Treasury. These profits accrue largely as a result of the income the Fed earns on its balance sheet holdings, and as the Fed's balance sheet has grown these remittances have increased accordingly. In the wake of the financial crisis and the unprecedented monetary policy response that followed, the interaction of fiscal and monetary policy has begun to change, a development that will have implications for both monetary and fiscal policymakers.

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[1] Labonte, M. Federal Reserve: Oversight and Disclosure Issues. (2016). Congressional Research Service, Library of Congress.

Together we'll go far

Figure 1

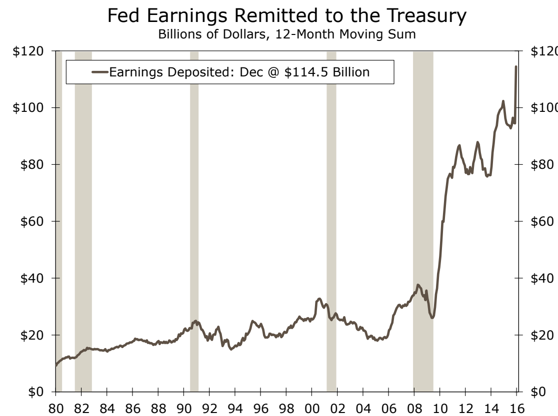
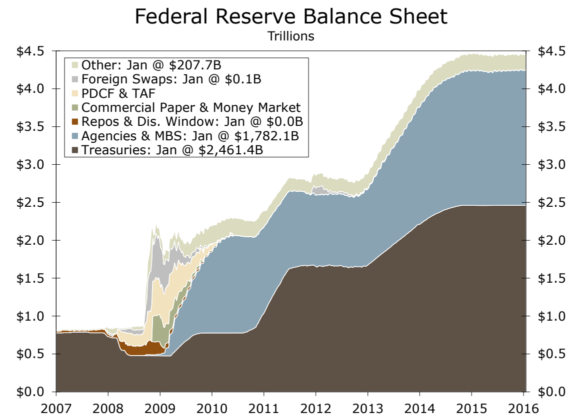


Figure 2



Source: U.S. Department of the Treasury, Federal Reserve System and Wells Fargo Securities, LLC

There has been some criticism of the Federal Reserve for the extent to which it intervened and the way in which the central bank responded to the financial crisis. This criticism has sparked debates on Capitol Hill about the role of the U.S. central bank and what tools it should be allowed to use in responding to economic and financial events. The unprecedented central bank response in the form of large-scale asset purchases, also known as Quantitative Easing (QE), has not only grown the size of the Fed's balance sheet but has also boosted remittances to the U.S. Treasury considerably. Figure 1 shows the growth in remittances to the Treasury over the past several years. From 1990 to 2006, on average the Federal Reserve remitted $22.7 billion in earnings to the Treasury each year. In 2014, the Federal Reserve remitted $102.3 billion.[2] The primary reason for the increase in remittances has been the interest earned on the assets held by Federal Reserve. In turn, these increased remittances have helped to lower the federal budget deficit in recent years. In addition, the exceptionally low interest rate environment over the past several years has helped to reduce the net interest expense of the federal government, also helping to put downward pressure on the federal budget deficit.

Implications for Monetary and Fiscal Policy

There are several implications for monetary policy and fiscal policy now that the Federal Reserve has begun to normalize monetary policy. First, there are challenges related to the Fed's surplus account given that Congress has mandated that surplus funds in the account be transferred to the Treasury. Second, there will be additional pressures on the federal budget as Fed remittances to the Treasury decline and interest rates rise. Finally, the unwinding of the unconventional monetary policy of the past several years will likely continue to increase the level of scrutiny on the Federal Reserve, which could call into question the level of independence of the U.S. central bank.

A reduction of the Fed's capital surplus account could hurt the Fed's credibility.

First, a reduction of the Fed's capital surplus account could hurt the Fed's credibility. As previously noted, Congress tapped the Federal Reserve's capital surplus account as a funding source in the recently passed highway bill. Traditionally, the Fed has retained some of its profits in this surplus account, and the account typically equals the amount of capital that private banks are required to pay in as members of the Federal Reserve System. This surplus account essentially acts as a "rainy day" fund which the Federal Reserve System maintains primarily as a cushion against losses. In addition, the account provides assurance of the central bank's strength and

[2] The Federal Reserve remitted $114.5 billion in calendar year 2015. However, a sizable portion was due to the required one-time transfer to fund highway and infrastructure projects spelled out in the Fixing America's Surface Transportation Act ("FAST Act").

stability.[3] This transfer to the Treasury occurred in December 2015 and represented a $19.3 billion (65.9 percent) reduction in the Fed's surplus account (Figure 3).

Currently, the Fed is turning a profit and remitting most of these profits to the Treasury. Even if a Reserve Bank were to incur a small loss, however, it could simply reduce remittances to the Treasury as an offset. Furthermore, even if the Fed were to suffer overall losses, in theory the Fed cannot go insolvent because it controls the printing presses and can always meet its obligations in U.S. dollars. Thus, despite Congress' actions regarding the capital surplus account, the Fed certainly seems unlikely to face a serious funding crisis in all but the most dire of circumstances.

Figure 3

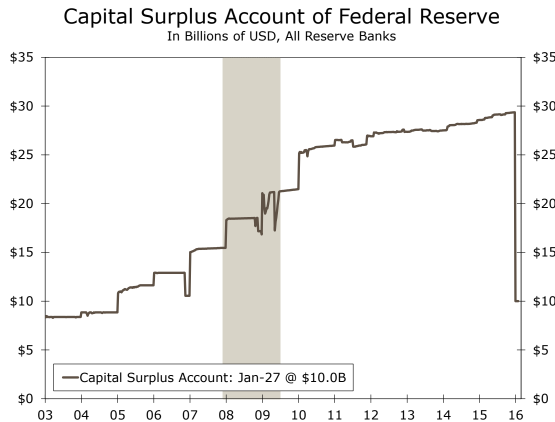
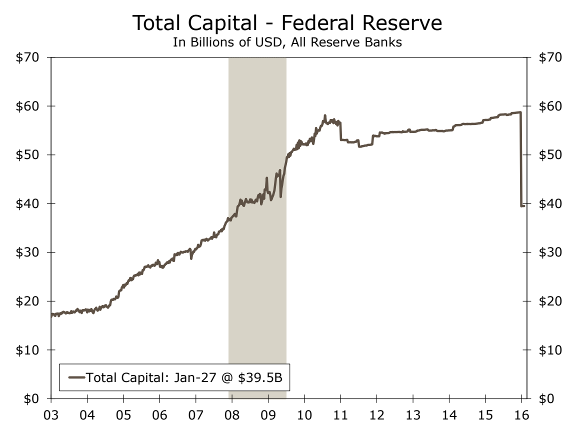


Figure 4



Source: Federal Reserve System and Wells Fargo Securities, LLC

Given the unconventional path of monetary policy and unprecedented expansion of the balance sheet, however, the last thing the Fed needs as it attempts to thread the needle on monetary policy is questions surrounding its capital solvency. Reducing the surplus account just as the Fed has begun the process of normalizing policy could introduce these questions. The Congressional Research Service has noted that tampering with the surplus account could negatively affect the Fed's credibility, adding that the Fed could be perceived as financially weaker or less self-sufficient and thus less independent of Congress and the Treasury.[4]

The last thing the Fed needs as it attempts to thread the needle on monetary policy is questions surrounding its capital solvency.

Compounding these credibility questions, a Fed working paper that studied the potential costs associated with various balance sheet normalization scenarios found that interest rate risk could lead to significant capital losses and further reductions in net income and remittances over time.[5] While we are not making the claim that the above scenario is the most likely outcome, if the Fed were in a position where it needed to reduce its balance sheet by selling assets in a rising rate environment, a significantly smaller capital surplus account would certainly do the Fed no favors in the face of potential losses.

Second, as a result of monetary policy action, fiscal policymakers may face additional budgetary pressures over the next several years. To begin, should the Fed suffer losses that result in low or zero remittances for an extended period of time, the budgetary impact could be serious. The Fed remitted, for example, over $100 billion to the U.S. Treasury in 2014. In a period of rising deficits, this loss of revenue would challenge lawmakers already struggling to find new revenue or cut spending and could induce additional political pressure and scrutiny from lawmakers. In addition, as the Fed normalizes interest rates and its balance sheet, these monetary policy actions are likely to have a significant impact on fiscal policy by increasing net interest costs. Despite

[3] **General Accounting Office. Federal Reserve System: The Surplus Account. (2002).**
[4] **Labonte, M. Legislation Eliminating the Federal Reserve's Surplus. (2015). Congressional Research Service, Library of Congress.**
[5] **Carpenter, S.B., Ihrig, J.E., Klee, E.C., Quinn, D.W., & Boote, A.H. (2013). The Federal Reserve's Balance Sheet and Earnings: A Primer and Projections. Federal Reserve Board.**

skyrocketing public debt as a share of GDP, net interest payments as a share of GDP have remained not only manageable but near historic lows (Figure 5).

Figure 5

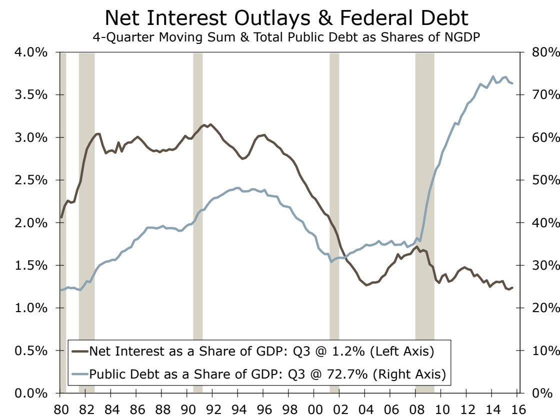
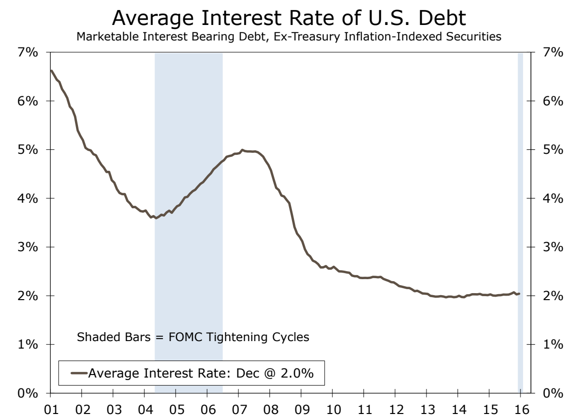


Figure 6



Source: U.S. Dept. of the Treasury, U.S. Dept. of Commerce and Wells Fargo Securities, LLC

Declining remittances and increasing pressure from net interest costs have the potential to create serious challenges for fiscal policymakers.

In December, the Fed began the process of raising rates, and although we expect the path of rate hikes to be more gradual than in previous tightening cycles, the effect on the deficit will likely still be significant. During the last tightening cycle, the average interest rate on U.S. debt increased by more than one percentage point (Figure 6). While this may not seem like much, even a moderate increase in interest rates on the more than $13 trillion in publicly held debt outstanding would lead to a sharp jump in net interest spending. The Congressional Budget Office projects that net interest payments will surge over the next decade, rising from $255 billion in 2016 (1.4 percent of GDP) to $830 billion (3.0 percent of GDP) in 2026.[6] Thus, declining remittances and increasing pressure from net interest costs have the potential to create serious challenges for fiscal policymakers.

The third main interaction with federal fiscal policy that has emerged as a result of the Fed's unconventional monetary policy has been increased scrutiny and in some cases intervention by Congress into monetary policy. The most recent highway bill, for example, officially called the Fixing America's Surface Transportation Act (or "FAST Act") and signed into law in December, resulted in an unusual cross between the monetary and fiscal worlds. Congress authorized a transfer of funds from the Fed's capital surplus account, a fund the Reserve Banks maintains to help cushion against losses as described above. If the unlikely scenario occurred where the Fed began to incur noteworthy losses, it could damage the Fed's credibility, which might affect its ability to effectively conduct monetary policy. Interestingly, using the one-time funding from the Federal Reserve according to the Congressional Budget Office "has no practical effect on the fiscal status of the federal government."[7] If the funds were left at the Federal Reserve, they would have earned interest and the balance would have been remitted to the Treasury anyway. Thus on net, the language of the FAST Act did not produce any new revenue for the federal government.

Beyond the legislation that uses the Fed's surplus account, there have been several pieces of proposed legislation to exert more control over the Fed, including having the Government Accountability Office perform an audit of the FOMC's interest rate decisions and a bill passed by the House of Representatives which would require the FOMC to abide by a rule to set interest rates and restrict the emergency lending powers of the Fed.[8] More fundamentally, the unprecedented response by the Federal Reserve to the financial crisis has resulted in greater Congressional scrutiny of the Fed's actions and policy responses. We refrain from commenting on

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[6] **Congressional Budget Office. (2016). The Budget and Economic Outlook: 2016 to 2026.**
[7] **Ibid**
[8] **Federal Reserve Transparency Act of 2015, S. 2232, 114th Congress. (2015).**
FORM Act of 2015, H.R. 3189, 114th Congress. (2015).

pending or proposed legislation; however, we think it is important to highlight the extensive academic research that shows the importance of central bank independence. Several studies, including Bade and Parkin (1982), Alesina (1988, 1989), and Grilli, Masciandaro, and Tabellini (1991) and more recently Dincer and Eichengreen (2014), find that central banks with greater independence are associated lower with levels of inflation.[9] The logic as presented in these works is that insulating monetary policy from the political process allows for a longer-run view of central bank policy that is insulated from short-term political pressures. While it is well established that central bank independence is correlated with lower rates of inflation, according to Alesina and Summers (1993) there is little evidence that central bank independence is related to real economic growth, unemployment or real interest rates.[10]

Conclusion

As we have explored, congressional action and proposed legislation over the past year has brought to light the intersection between fiscal and monetary policy. The unconventional response by monetary policymakers in the wake of the financial crisis, as well as the unwinding of these unconventional policies, has resulted in a growing link between fiscal and monetary policy. This in turn has increased the level of scrutiny on the Federal Reserve Board by Congress, raising the prospect of reduced U.S. central bank independence. The well-established link between central bank independence and the ability of a central bank to keep inflation in check intimates that ensuring a separation between the politics of fiscal policy and actions of monetary policy is the best way to fulfill one of the mandates of the Federal Reserve of low inflation. While there will continue to be ongoing interactions between fiscal and monetary policy, the degree to which the two interact in the future will have important implications for investors should the Fed's credibility or ability to control inflation become impaired by reduced independence.

Ensuring a separation between the politics of fiscal policy and actions of monetary policy is the best way to fulfill one of the mandates of the Federal Reserve of low inflation.

[9] Bade, R. and Parkin, M. (1982). Central Bank Laws and Monetary Policy.
Alesina, A. (1988). Macroeconomics and Politics. In NBER Macroeconomics Annual 1988, Volume 3. Fischer, S. (Ed.), pp.13-62. Cambridge, MA: MIT Press.
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Dincer, N.N. and Eichengreen, B. (2014). Central Bank Transparency and Independence: Updates and New Measures. International Journal of Central Banking, Volume 10, No. 1. pp. 189-253.
[10] Alesina, A. and Summers, L.H. (1993). Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence. Journal of Money, Credit and Banking, Volume 25, No. 2 pp. 151-162.

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