# Random Refereeing:
# How Uncertainty Hinders Economic Growth
## (*With Reference to Lucky Puppies, Pepper…and Salt, Lawrence Summers and Thomas Jefferson*)

*Remarks before the Greater San Antonio Chamber of Commerce*


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Jim Goudge has been of enormous help to the Dallas Fed over the years, serving first as a member of the board of our San Antonio Branch and more recently as a member of the Federal Advisory Council, a body that consists of a banker from each of the 12 Federal Reserve Districts and advises the Federal Reserve Board about banking conditions nationwide. Before I get started, I want to thank you, Jim, for your devoted service to our nation's central bank. And I thank you for that kind introduction.

Jim asked me here today to provide some comments on the current economic situation. That is no simple task. My undergraduate economics professor John Kenneth Galbraith used to say that "the only function of economic forecasting is to make astrology look respectable." Economic prognostications need to be taken with a grain of salt, even when delivered by Federal Reserve officials, for they are seldom accurate and are subject to constant revisions. But this much I know: Economic growth is no longer being aided by the inventory correction that propelled the economy in the fourth quarter of last year and the first quarter of this year. And software and equipment purchases are closer to catching up with demand. Against this background, recent relatively weak data indicating slower manufacturing growth, a dyspeptic housing sector and continuing consumer anxiety point to a slightly weaker national outlook, with growth from the first quarter onward likely to fall below 3 percent for a prolonged period.

Recent data from the Eleventh District are also a mixed bag. Year-to-date through June, our fellow Texans have accounted for over 18 percent of the nation's overall private sector job creation and about 44 percent of jobs created in the goods-producing sector. So we have been lucky puppies. While commercial real estate and recent readings from the Dallas Fed's Texas Manufacturing Outlook Survey (which was released on Monday) are weak, exports have been on an upward trend, and we've seen positive employment growth, especially in the energy, construction and—despite a significant drop in consumer confidence for the month of June—retail sectors. Job growth in Texas for 2010 is forecasted between 2.5 and 3 percent, which implies around 250,000 to 300,000 new jobs.

At both the national and regional levels, despite a series of hiccups and roadblocks, we continue our slow slog out of what proved to be a most hellish downturn in 2008 and 2009. I expect the economic expansion to continue, buoyed by slow and admittedly bumpy improvements in the labor market, increases in business and household spending, and resilience in entrepreneurial hot spots like Texas. But, on net, I fear the nation's economy will be sailing forward at suboptimal speed, despite the fact that the cost of borrowing is low, equity markets have shown resilience and liquidity is plentiful on corporate balance sheets and in the form of excess reserves in the banking system.

For some time now in internal discussions with my colleagues at the Fed, I have ascribed the economy's slow growth pathology to what I call "random refereeing"—the current predilection of government to rewrite the rules in the middle of the game of recovery. Businesses and consumers are being confronted with so many potential changes in the taxes and regulations that govern their behavior that they are uncertain about how to proceed downfield. Awaiting clearer signals from the referees that are the nation's fiscal authorities and regulators, they have gone into a defensive crouch.

In the past few weeks, the popular press has expounded upon this theme. Articles about the price of uncertainty have come from seemingly all corners, with everyone from Mort Zuckerman in the *Financial Times* to Fareed Zakaria in the *Washington Post* to David Leonhardt in the *New York Times* complaining about how uncertainty perpetrated by fiscal and regulatory authorities is undermining economic expansion.[1] Writing in the *Wall Street Journal* about the banking industry's concerns with the unfinished business of the recently enacted financial regulatory reform legislation, David Reilly summed up the situation well: "Certainty … will give banks clear targets," he said. "Not knowing [the outcome] is arguably the worst of all worlds."[2]

This view is by no means unique to bankers. Private sector operators—the most efficient creators of sustainable, long-term economic growth and innovation—find themselves stymied as the rules of the road remain ambiguous and the outcome or the full effect of recently enacted legislation and regulation remains unknown.

Capitalism works best when people take sensible, calculated risks in innovating and conducting normal economic activity. Uncertainty and risk are natural parts of business—capitalists handicap and deal with them every day. However, excessive uncertainty hinders one's ability to even calculate the odds of potential outcomes—especially when that uncertainty involves irreversible decisions with long-term implications.

Operating a business under conditions of excessive uncertainty is like playing a game when you don't know the rules. Without rules, it is impossible to develop a strategy or playbook. Business leaders are forced to call a time-out: They remove their players from the field and anxiously wait on the sidelines until they have a better idea how to play the game. Too much uncertainty can create economic stasis as more and more decisions get delayed, retarding commitments to expansion of payrolls and capital expenditures and slowing the entire economy.

Before every meeting of the Federal Open Market Committee (FOMC)—the forum in which we make monetary policy decisions at the Fed—I survey some 25 to 30 business leaders, large and small, from a group of 50 or so that I have developed over the years to provide me a sense of what is being seen from the economy's operational side in most every sector. I have reported to my colleagues at the FOMC that the prevailing sentiment among these business operators is that the politicians and officials who craft and enforce the rules are doing so in a capricious manner that makes long-term planning difficult, if not impossible. They are increasingly distressed by the lack of consistent direction coming from Washington. They are confused and dispirited by random refereeing. So they are calling time-outs and heading to the sidelines while they wait for the referees to settle on the rules of the game.

[1] "Obama Needs to Stop Baiting Business," by Mort Zuckerman, *Financial Times*, July 27, 2010, p. 9; "Obama's CEO Problem—and Ours," by Fareed Zakaria, *Washington Post*, July 5, 2010; "5 Ways Congress Can Bolster Growth," by David Leonhardt, *New York Times*, July 6, 2010.
[2] "A Growing Debate about Safety," by David Reilly, *Wall Street Journal*, July 12, 2010.

If this is so, no amount of further monetary policy accommodation can offset the retarding effect of heightened uncertainty over the fiscal and regulatory direction of the country. As long as our economic players—businesses and consumers—are beset by unmanageable uncertainty, they will refrain from making decisions that provide the stuff of economic growth. Indeed, one could posit that further monetary accommodation might make the situation worse if private sector operators were to conclude that the Federal Reserve has become politically pliable and is prone to substituting such accommodation for fiscal discipline.

Let me turn to what I hear from businesses, the players on the field.

***Fiscal Policy Uncertainty***

I'll begin with the debts and deficit figures.

Except when consumer demand is anemic, large fiscal imbalances adversely affect economic performance in at least three ways: They crowd out private-sector economic activity; they hinder policymakers' ability to run a loose fiscal ship during recessions to allow individuals to smooth their consumption over the business cycle; and, finally, they raise the probability of a debt crisis. To be sure, when the chips are down, deficit spending is considered an orthodox practice in order to stimulate economic recovery. And the United States enjoys unique advantages that insulate it to some degree from the deleterious effect of deficits. But such insulation could and likely would be eroded over time if our fiscal imbalances swell to the extent currently predicted. By latest accounts, under the least felicitous conditions (what the Congressional Budget Office recently called an "alternative fiscal scenario"), publicly held debt bests the all-time high of 109 percent of GDP around 2025 and reaches a staggering 185 percent of GDP by 2035—more than twice the level of debt at which some economists believe significant crowding-out of private-sector economic activity occurs. This is not the baseline scenario. But the possibility of it occurring, however remote, frightens business operators, for they are uncertain not only about whether fiscal authorities will actually mitigate this risk, but also how they might go about doing so.

Policymakers, for example, have had nine full years to decide the fate of the Bush tax cuts but have yet to do so. This delay introduces uncertainty on a host of tax rates, including income taxes, estate taxes, capital gains taxes and dividends taxes. Such uncertainties have implications for business and household financial decisions.

Corporate and small-business taxation is another murky area, as many of you know. And, despite recent actions taken on Capitol Hill, certainty remains evasive. Certain S corporations, for example, still fear being assessed a 15.3 percent payroll tax in the future. Investment managers do not know whether their carried interest will eventually be taxed as ordinary income. Businesses that are contemplating equipment purchases do not know whether "bonus depreciation" will be in place at the time they make these very large purchases. And the oil and gas sector does not know whether it will lose $35 billion in tax breaks when pending legislation is finalized. It is pretty hard for businesses to budget and plan for the future with these tax issues still up in the air.

Another issue, of course, is health care. Here again, there are many examples of uncertainty and its deleterious effect on economic decisionmaking. Doctors do not know whether a planned 21 percent Medicare reimbursement cut will take effect and hence do not know what kind of investments to make in their practices. Firms remain uncertain as to whether their current health plans will be grandfathered in or whether it will even make financial sense for them to provide employee health benefits once they make their way through the fine print. Medicare providers do not know whether the so-called cost curve will be bent and, if so, whether it will be done at their expense. Baby Boomers—like me—do not know how or whether they will receive promised benefits or whether those benefits will be pared back to address ever-growing unfunded liabilities. And literally hundreds of provisions in the recent health care reform law are currently being interpreted and fleshed out by government officials, with significant though unknowable financial stakes for individuals and firms alike.

You may have seen a comical snapshot of these issues in the *Wall Street Journal*'s "Pepper…and Salt" cartoon on July 2. In it, a mechanic lays out the various costs associated with a customer's recent repairs as follows: "That's $117 for parts, $75 [for] labor […] and $321 for employee health care."[3] This, of course, would be humorous were it not so revealing: No business can cost out the provisions for health care because no business can be certain of the cost of adding employees to the payroll. As a result, high unemployment lingers, consumption—which historically has driven about 70 percent of our economy—is undermined and, thus, the economy limps along.

All of this ignores the uncertainty created by even broader fiscal debates: whether last year's stimulus package has sufficiently boosted the economy or further stimulus is needed; whether historically large levels of government spending must remain in place or should be trimmed back. Business operators, faced with uncertainty on all these fronts, watch anxiously from the sidelines for these questions to be answered.

If firms and individuals at least know how much emphasis policymakers will place on debt reduction over the next few years, they could perhaps make informed guesses about just how "random" fiscal "refereeing" will be. But in a tumultuous economic climate accompanied by extraordinary economic and political divisions, it is perhaps unsurprising that there is no consensus on even what the general thrust of fiscal policy should be, let alone which specific provisions should be adopted.

Let me close this discussion of fiscal uncertainty with one more thought. Some of you may wonder whether our elected officials, faced with the truly monumental task of balancing the nation's books, might simply throw in the towel and turn to the Fed to print us out of this enormous fiscal hole. If such a request were ever made, there should be no uncertainty: We at the Fed cannot and will not monetize the debt. We know what happens when central banks give in to those requests—it leads us down the slippery slope of debasing our currency and puts us on the path of hyperinflation and economic destruction. Neither I nor my colleagues are willing to risk that legacy.

In this regard, let me add that the Federal Reserve is absolutely committed to its goal of achieving price stability. This entails keeping inflation extremely low and stable. Neither inflation nor deflation will be tolerated.

[3] "Pepper…and Salt," *Wall Street Journal*, July 2, 2010, p. W10.

The United States has just emerged from a long and deep recession, caused in part by a series of deflationary shocks: a housing bust, a stock market crash and an implosion of the banking industry, to name a few of the more obvious.

The FOMC implemented a monetary policy stimulus to offset the deflationary forces it faced in 2008 and 2009. The Fed grew its balance sheet when both businesses and households were deleveraging and seeking to shrink their balance sheets. Deflation was averted, and inflation will be averted as the Fed slowly reduces the size of its balance sheet when private sector deleveraging begins to slow and reverse. Again, price stability is the ultimate goal, and the Fed is absolutely committed to this objective.

***Financial Regulatory Uncertainty***

The problems posed by uncertainty are perhaps nowhere more evident than in the financial regulatory reform bill recently debated on the Hill and signed into law by President Obama last week.

The Dodd–Frank Wall Street Reform and Consumer Protection Act offers a number of compelling examples of how regulatory uncertainty could hinder economic growth. A 2,300-page bill is bound to contain some mysteries within its passages (even after it was recently reformatted to a mere 848 pages). But given that the legislation has delegated much of the actual implementation to regulators, passage of the bill has done little to reduce the level of ambiguity in an already uncertain financial sector.

It is undoubtedly true that we live in complex times—perhaps more complex than most in recent memory. But if the scope of financial reform legislation is any measure, complexity has grown exponentially. The Banking Act of 1933—the Glass–Steagall Act—was passed in the midst of the Great Depression and represented a major overhaul of the regulatory system by establishing the FDIC, the FOMC and a separation between commercial and investment banking. Congress was able to accomplish these historic tasks in a bill that contained only a single title, 34 sections and was less than 40 pages long.

Legislation to repeal Glass–Steagall, the Gramm–Leach–Bliley Act, was passed in 1999 with seven titles and 20 subtitles. There were a total of 141 sections, all contained in about 145 pages. Complexity marches on.

Fast forward to today. While the financial crisis that we just experienced was considered by many to be second in intensity only to what took place during the Great Depression, the question naturally arises: How is the business and financial community to interpret 2,300 pages, 16 titles, 38 subtitles and a total of 541 sections of legislation designed to deal with our recent travails?

There are some things we know with certainty as a result of this legislation. We will have a new Financial Stability Oversight Council to monitor systemic risk; a new resolution authority for nonbank financial companies; enhanced regulation and oversight of the derivatives markets; and a new Bureau of Consumer Financial Protection.

Unfortunately, it's what we don't know that looms especially large. Even beyond the possible unknown or hard-to-find explicit provisions contained within 2,300 pages, and even beyond the need for "technical corrections" to come, the wide array of rulemakings that are left to federal regulators fosters ever-more uncertainty. Take, for instance, Title I of the act ("Financial Stability") and its directives to my colleagues at the Federal Reserve: There are close to 20 instances where the Fed must either promulgate rules and regulations or is authorized to do so. This does not even include those requirements where the Fed must act in conjunction with another regulatory agency.

For example:

Title I states that "The Board of Governors shall establish, by regulation, the requirements for determining if a company is predominantly engaged in financial activities …"[4]

It goes on to prescribe a vexing combination of "shall" and "may":

"The Board of Governors … *shall* establish prudential standards for nonbank financial companies supervised by the Board of Governors and bank holding companies …" And "The Board of Governors *may* establish additional prudential standards for nonbank financial companies supervised by the Board of Governors and bank holding companies …"[5] What we *shall* and what we *may* do await articulation.

These are just a few examples of the act's regulatory discretion that count toward what the *Wall Street Journal* reported as a conservative total of 243 rulemaking requirements on the part of 11 different federal agencies.[6] As the president's chief economic adviser Larry Summers put it recently: "This is a framework that has the *potential* to be as modern as the markets, but its efficacy will certainly depend upon the judgments that regulators make."[7]

This leaves those affected by the legislation hanging on the cliff of uncertainty until we at the Fed and other regulators issue clear directives. And the uncertainty does not stop there. How will the landscape be sculpted by the new Bureau of Consumer Financial Protection, and how will potential conflicts between this bureau and other financial regulatory agencies be managed? What will come of the Treasury's study, as mandated by the act, of Fannie Mae and Freddie Mac? What capital requirements and eventual exemptions in over-the-counter derivatives transactions will be established? If the FDIC is directed to "conduct its [resolution] operations in a manner that … mitigates the potential for serious adverse effects to the financial system," how plausible is it that this resolution authority will really end "too big to fail" and associated taxpayer bailouts?[8]

Regardless of how you feel about the recent reform efforts' broad goals, I hope you see my point: This is not the best time for added uncertainty, especially when the banking industry appears to be on a very slow mend. Yet uncertainty reigns.

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[4] Citations are from the Dodd–Frank Wall Street Reform and Consumer Protection Act text, which can be found on the Government Printing Office website at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf. Section 102.
[5] Section 165. Italicized portions are speaker's addition.
[6] "The Uncertainty Principle," *Wall Street Journal*, July 14, 2010.
[7] As quoted in "Congress Passes Major Overhaul of Finance Rules," by Binyamin Appelbaum and David M. Herszenhorn, *New York Times*, July 16, 2010. Italicized portion is speaker's addition.
[8] Section 210.

The bottom line is this: In whatever realm and whatever form, excessive uncertainty is the enemy of economic growth. As Ben Bernanke wrote in 1980, the "resolution of uncertainty" can lead to "[a business] investment boom."[9] It follows, then, that if and as regulators and legislators provide more clarity, a major roadblock to economic growth will be removed.

It was recently reported that nonfarm, nonfinancial firms in the U.S. have over $1.8 trillion worth of liquid assets sitting on their books. Excess bank reserves being parked in the 12 Federal Reserve Banks exceed $1 trillion. If and as the incidence of "random refereeing" and uncertainty is assuaged, then we might well have the opportunity for robust growth in employment and capital expenditure expansion as firms and banks put that excess cash to use. That's the good news.

So, how do we proceed from here?

First, we at the Fed must continue to comport ourselves in a manner that exorcises any lingering worries about our willingness to brook any political interference with our commitment to fostering price stability and maximum sustainable employment. We delivered on our duty to restore liquidity to the commercial paper, asset-backed securities, interbank lending and other markets. We then closed out all of our extraordinary liquidity facilities, doing so without costing the taxpayer a dime (imagine that: a government agency that closes programs after they have outlived their usefulness!). We have worked hard to earn the respect of the marketplace and of the nation, and we dare not risk it at a time when there is so much uncertainty elsewhere.

Second, our political leaders should muster the courage to pull up their socks and strike a better balance between the long-term need to keep government debt low and the short- to medium-term need for an appropriate level of fiscal stimulus.

Finally, it is important that we obtain clear and forthright government policies. Businesses can pursue their economic interests only if government honors its commitments and ensures a fair and equitable playing field. Unclear policies and undefined regulations create uncertainty and instability that bollix long-term planning. Those responsible for enforcement of recently passed reforms need to focus with laser-like intensity on addressing the regulatory indigestion that has engulfed our economy.

Until business operators are provided the clarity they need, they will continue to hoard their cash, limit their payrolls and constrain investment in new plant and equipment—none of which provides hope for the unemployed or will put us on a more forceful path to recovery.

Thomas Jefferson is credited with saying, "In matters of style, swim with the current; in matters of principle, stand like a rock." We at the Fed have done all we can to stand like a rock on the principle of good monetary policy. It is now time for our fiscal agents to take a principled stand and act in the long-term interest of the nation rather than in the fashion of the moment.

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[9] "Irreversibility, Uncertainty, and Cyclical Investment," by Ben Bernanke, National Bureau of Economic Research, Working Paper no. 502, July 1980. A revised final version of this paper was published under the same title in the *Quarterly Journal of Economics*, vol. 98, no. 1, 1983, pp. 85–106.