Fiscal Policy vs. Monetary Policy - Transcript

Tom Mullooly: In episode 61, we're going to have a quick course on fiscal policy versus monetary policy.

Welcome to the Mullooly Asset Show. I'm your host, Tom Mullooly, and this is episode number 61. We get these topics from our viewers, our listeners and our clients, so if you've got a question, it doesn't matter if it's a financial planning question or an investment question or an educational kind of question, bring it on. Let's hear it. You may wind up seeing your question in a video or in one of our podcasts or one of our blog posts. Tim, what are we going to be covering today?

Tim: **What's the difference between fiscal policy and monetary policy?**

Tom Mullooly: Okay, this is a great topic. People throw these titles around, these terms. I don't think they truly understand what they mean, the difference between fiscal and monetary policy. Monetary policy is put in place by the federal reserve. Fiscal policy is put together by our friends in Washington, DC. The first thing we need to know is when the federal reserve was created in 1913, it was given a couple of goals. The first goal is that it needs to make sure that the economy has some kind of sustainable growth. The second goal is full employment. Later on, they were tasked with another goal, and that was to make sure that the economy has stable prices. That we don't have runaway inflation or deflation.

We need to know what the goals of The Fed are first, so we can talk about monetary policy. The way that they monitor to make sure that they have sustainable growth is by watching GDP, which is Gross Domestic Product. That's how they measure the rate of growth from quarter to quarter and year over year. The second thing that they need to keep an eye on is the rate of employment. The way they manage that is they track non-farm payroll. We get the unemployment figures and non-farm payroll reports on the first Friday of every month at 8:30 in the morning.

The third goal that they have, which is to make sure that the economy has stable prices and doesn't have runaway inflation, they monitor CPI, which is the Consumer Price Index. That's a measure of inflation. Now, their inflation measures don't always match up with our inflation numbers. We can say, "Hey we're going to the supermarket, and we're finding out the price of everything is going up," but The Fed says, "We don't see any indications of long term inflation going on in the economy. They may be temporary blips."

So how does The Fed ... They can either do one of two things. They're either going to stimulate monetary policy or they're going to restrict monetary policy. How do they stimulate policy? The first thing I want you to think about is when The Fed's doing something, it's kind of like if you were buying or selling in your own investment account. When you buy, say, a bond, what actually happens in the account? You're getting a bond and you're putting it in your account. What goes out of your account? Money. The money goes somewhere else. So when The Fed wants to stimulate the economy, they're going to buy bonds from off the street and they're going to push cash into the banks, into the brokerage firms, into the economy to help stimulate things. Okay. They can also lower short term interest rates, which is the amount that banks get charged to borrow money. So The Fed has a couple of tools at their disposal to stimulate monetary policy.

What do they do when they're restricting policy? Well, they're doing really just the opposite. The example I gave before, when they're buying bonds, cash is going out. Now when they want to restrict policy, what are they going to do? They're actually going to be selling bonds into the market, and what do they get back? When they sell a bond, they get money back. They're actually taking money out of the system, so they're draining money from the system. The Fed can also raise short term interest rates, the rates that banks get charged to borrow money from The Fed, and those two triggers are really the two levers that they've got that they use a lot. There's others that they have, but those are really the main ways that they can restrict monetary policy.

When we talk about The Fed and we talk about rates, it's important to understand that there's two main rates that The Fed can set. The first one is The Fed funds rate. It sounds like, "Well that's the rate that The Fed would charge me," but it's not. The Fed funds rate is actually the rate that banks charge each other to make sure that their reserve level at the federal reserve stays the same. If my bank is going to borrow, I've got a deficiency and I'm going to borrow from Tim's bank, I'm going to pay Tim's bank a rate of interest, an overnight rate, so my reserves can stay where they're supposed to be at The Fed. So there's The Fed funds rate.

The other rate they have is called the discount rate. And that actually is the rate that The Fed charges a bank when a bank has to borrow money directly from The Fed. The Fed, when they're changing their rates, they can charge the discount rate or they can charge, meaning change, raise or lower The Fed funds rate. They can change either or both of those tools.

Now, I want to go back to 1981, 1982 because things really happened in a 12 month period of time that really changed things, not really all that long ago, 35 years ago. In 1981, we saw inflation peaking and then we saw inflation start to drop. And we saw interest rates, because The Fed didn't need to keep interest rates that high, so the interest rates started coming down. So we had inflation dropping, we had The Fed lowering rates. Those are two good recipes for stock market success, but then we had something else happen. Washington, Reagan and Congress were working on a huge tax cut plan to stimulate the economy. In fact, the tax cuts or fiscal policy, started before inflation and interest rates started dropping. And so, now I want to shift to fiscal policy.

The only way fiscal policy can change is to get these knuckleheads in Washington to get their act together and work on reducing the deficit, reducing taxes. Fiscal policy swirls all around what happens with taxes, with tax revenue and spending cuts. This is such a huge deal. If you think about it, our friends in Congress haven't done anything about changing the tax code or the tax structure in years. We've had high fiscal policy, in the sense that tax rates are high, spending is higher because we have a deficit every year, and that deficit gets added to the debt, which eventually we have to service. We have to pay interest on that. We need to find a way where we can get a good balance between monetary policy, what The Fed does, and fiscal policy, what Congress does.

I wrote several blog posts on our site over the last few years where quantitative easing and The Fed had done, they lower interest rates to zero. They then did quantitative easing. We got to a point where there was really nothing else that The Fed could do to help stimulate the economy. We needed Congress at some point to get their act together and start working on fiscal policy. Some kind of fiscal solution that's going to help stimulate growth in the economy. 2017 we still haven't seen it yet. I don't want to get into an editorial, but The Fed has done everything that they can for the last 10 years to get the economy moving. Now it's up to the fiscal side to get things going.

Hate to end it on a downer, but that's the difference between fiscal policy and monetary policy. Thanks for watching episode 61. We look forward to seeing you on the next one. Thanks.