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Fiscal Policy is the Signal

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In Nate Silver's book *The Signal and the Noise*: *Why So Many Predictions Fail – but Some Don't*, he discusses the underlying trend as the signal and the random events that surround it as noise. Daily events can easily distract from momentum, and it is easy to see patterns developing that really aren't there.

I have spent a lot of time the last couple of years worrying about when the post-2008 era will end and the system will clear. The market, as measured by a broad based US equity index like the S&P 500, has not gone down in any calendar year since then. This is uncharted territory, and it is my belief that it has stayed high artificially. This is very worrying because all government policies must mean revert past their trend line periodically. This has not happened in many years.

Governments have several tools available to them. They can speed things up in the economy by reducing regulation, or slow them down with an increase. One shortcoming of this part of the system is that it seems to only work in one direction. When the economy is growing robustly it seems no one is willing to slow down the party. Second is fiscal policy. Governments can spend more than they collect to stimulate the economy. Again, this rarely works as smoothly to slow the economy as it does when an event has caused a slowdown. Finally, monetary policy can stimulate or slow the economy by adjusting several (growing) tools. They can buy/sell bonds, change interest rates required to borrow from the Fed, or even buy and sell assets.

The recent environment has been to reduce regulations (increasing trade), high spending by governments, and loose monetary policy. Some would say we are in a currency war, with each government in turn reducing the value of their currency to attempt to increase exports and create jobs. What no one is talking about is the dominance of fiscal policy in these choices. Monetary policy was designed to work when fiscal budgets were balanced. Carmen Reinhart and Ken Rogoff, in *This Time is Different*, talk about how historically countries have defaulted (or lost control of their currency) after the central bank started to buy up the fiscal debt. It is hard to see how the system can clear, meaning balanced budgets and neutral monetary policy, without severe displacement to the world economy.

Every day we hang on the Federal Reserve Bank Governor's every words, while Congress fails to address climate change, open Supreme Court vacancies or funding for the Zika virus. There are tough choices ahead, but they are mostly on fiscal issues. The monetary policy issues will be challenging, there is no doubt about that, but they are mostly noise when compared to the important fiscal issues that need to be addressed. The current election is not helping, with anti-trade rhetoric active on both sides of the aisle. Tariffs will only make things worse.

What year are we in today: arguments can be made for 1928, 1971, 1937, and 1977. Poor outcomes followed all of these times.

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