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Saving the Fed From Itself

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The Federal Reserve is pursuing a very risky monetary policy. Its leaders — the departing chairman, Ben S. Bernanke, and the vice chairwoman, Janet L. Yellen, whom President Obama has nominated to succeed him — are correct that the American economy needs more stimulus, and they believe that the central bank, because of political paralysis, is the only game in town. But if Congress and the Obama administration could agree on a fiscal stimulus that goes beyond a short-term budget deal, the Fed would not have to take such risks.

The Fed's strategy has been to stimulate the economy by driving down long-term interest rates by amassing long-term bonds and pledging to keep short-term rates near zero. A result has been to increase home and stock prices and, by lifting household wealth, encourage consumer spending.

But the magnitude of the effect has been too small to raise economic growth to a healthy rate. Home building has increased rapidly, but from such a low level that its contribution to gross domestic product has been very small. And the increase in total consumer spending has slowed, despite the soaring stock market.

The net result is that the economy has been growing at an annual rate of less than 2 percent. (The latest estimate, that the economy grew at an annualized rate of 3.6 percent in the third quarter, overstates the strength of demand because half of that increase was just because of inventory accumulation.) Weak growth has also meant weak employment gains. The decline in unemployment, to 7 percent, as announced on Friday, has largely reflected the decreasing number of people looking for work. Total private-sector employment is actually less than it was six years ago.

While doing little to stimulate the economy, the Fed's policy of low long-term interest rates has caused individuals and institutions to take excessive risks that could destabilize the economy just as it did before the 2007-9 recession. It has pushed up the values of everything from Iowa farmland to emerging-market bonds. Banks are lending to lower-quality commercial borrowers. Households are seeking higher returns by investing in real estate trusts and other high-risk products.

Although the Fed is expected to "taper" its bond buying, its promise to keep long-term interest rates abnormally low means that it is unwittingly encouraging private investors and institutions to continue to take risks.

A bipartisan House-Senate conference committee on the budget is closing in on a compromise, before the House adjourns for the year, on Friday, that would limit the across-the-board budget cuts known as the sequester and prevent another government shutdown. But even this modest deal would not produce the kind of long-term fiscal policy needed to achieve strong income and employment growth.

To get the economy back on track, President Obama should propose, and Congress should enact, a five-

year fiscal package that would move the growth of gross domestic product to above 3 percent a year and focus on direct government spending on infrastructure.

Although the mission of the military has been reduced with the end of the wars in Iraq and Afghanistan, there is also substantial need to replace and repair the equipment of the armed forces. Some of this aid could also extend to state and local governments.

The total price tag over five years would have to exceed $1 trillion to achieve the needed rise in the economic growth rate. The lack of “shovel-ready” projects is not an excuse for not pursuing this strategy or for diverting the funds into income transfers and other low-impact spending of the kind that made the 2009 stimulus so ineffective. It would be better to spend a year or two preparing for the right kind of spending.

It would be irresponsible, however, to add another trillion dollars to the national debt without higher revenues or lower spending. Doing so would frighten financial markets and business executives, reducing private spending and offsetting the stimulus’s benefits.

The key, therefore, is to combine a major short-term fiscal stimulus with long-term deficit reductions that would cause the ratio of debt to gross domestic product to begin declining by the end of this decade. Slowing the growth of Social Security and Medicare and raising revenue by limiting the subsidies that are built into the tax code could shrink future deficits to less than 2 percent of gross domestic product, enough to put the debt-to-G.D.P. ratio on a path back to the 40 percent level that we had before the recession. That should be the goal for this Congress or the next one. And it would allow the Fed to stop trying to shoulder — with increasing futility — the burden of saving the economy all by itself.

Martin S. Feldstein, a professor of economics at Harvard, was the chairman of the Council of Economic Advisers from 1982 to 1984 under President Ronald Reagan.