

Testimony, Joint Economic Committee

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Vice Chairman Brady, Senator DeMint, Members of the Committee.

It is a pleasure to appear again before the Joint Economic Committee. My association with this committee goes back to the days of Senator Paul Douglas. It was Sen. Douglas who pushed and prodded the Federal Reserve to stop holding interest rates fixed and permit monetary policy to do much more to prevent inflation. His views eventually prevailed. That should remind the members of their responsibility.

Today, I will answer the questions that this hearing topic seeks to address. The question of “what is the real debt limit” includes some good questions that show rising concern for the consequences of recent Federal Reserve actions. I will introduce my answers with my explanations of why Federal Reserve policy is misguided and mistaken, inflationary and inappropriate. There are several reasons. I will give three.

First, in writing the three volumes of A History of the Federal Reserve, I read more minutes and transcripts than any person can endure. With very rare exceptions, notably in the years when Paul Volcker led the disinflation policy, one looks in vain for a statement of the medium-term consequences of the actions taken at the meeting. True, the staff and others provide forecasts of the future, but the FOMC never tries to reach agreement on the consequences of its actions for the public. It publishes forecasts but there is no clear relation between forecasts and actions.

Second, concerns at FOMC meetings are mainly about the near-term. The Federal Reserve has little influence over what will happen in the near-term but much greater influence on the medium-term. The present is characteristic. The Fed Chairman and some of the members seem determined to “do something” more about the excessive waste and harm of high unemployment. They neglect the

fact that there is no shortage of money and liquidity and that they have pushed and prodded market interest rates to the lowest levels ever achieved. THE UNITED STATES DOES NOT HAVE A PROBLEM OF TOO LITTLE LIQUIDITY. THERE IS NOT MUCH THAT THE FEDERAL RESERVE CAN DO BY ADDING RESERVES OR LOWERING INTEREST RATES. Doesn't the Chairman and several members understand that there are limits to what the Federal Reserve can do? Banks hold more than \$ 1.5 trillion of idle reserves. Money growth (M2) for the past 6 months is rising at almost 15 percent annual rate. (See chart.) Prices are rising and the US dollar continues to sink. THE MOST USEFUL ACTION WOULD BE ANNOUNCEMENT OF AN ENFORCEABLE INFLATION TARGET TO GIVE CONFIDENCE THAT WE WILL NOT INFLATE.

Third, in 1977 Congress gave the Federal Reserve a dual mandate, interpreted as low unemployment and low inflation. It pursues those goals in an inefficient way by pursuing unemployment until inflation rises, shifting to inflation control until unemployment rises, and back and forth. That way, it achieves neither. The Great Inflation of the 1970s is an example. Both unemployment and inflation rose. The current Fed repeats that pattern. In contrast, policy from 1985 to 2003 more or less followed a rule that included both goals. That gave the public one of the very few years of low inflation and stable growth in the Fed's 100 year history. In Article 1, Section 8 our constitution gives Congress ultimate control of money. It should legislate an enforceable inflation target. I will amplify "enforceable" if you wish.

Now to the more specific questions of the real debt limit.

First, given the fiscal policy of the industrialized nations, will government debt crowd out private investment spending? My answer is yes. Today's deficits and debt raise concerns about future tax rates. The prospect of higher future tax rates raises the rate of return that business investors want to earn on new investment. And uncertainty about future tax rates and the persistent increase in regulation of health, labor, energy, and finance has deterred investment and slowed recovery. Faced with heightened, current uncertainty, many investors hold cash and wait. Cash is their friend. Government budget and regulatory policies deter, crowd out, investment.

Second, the original Federal Reserve Act prohibited loans to the Treasury. Early in its history the Federal Reserve circumvented the prohibition by buying Treasury bonds from the market after the Treasury sells them. This monetizes debt. With

the exception of wartime, the Federal Reserve bought mainly very short-term Treasury bills. In the 1950s, it ran a “bills only” policy. Recently it has done what no central bank should do: It has implemented the government’s fiscal policy by buying long-term Treasury bonds and \$ 1 trillion worth of mortgage-backed securities. Ask them how they plan to sell mortgages in this mortgage market. The screams from homebuilders would be heard all across the country. A straightforward way of saying the same thing is that THE FEDERAL RESERVE DOES NOT HAVE A CREDIBLE PROGRAM FOR SHRINKING ITS BALANCE SHEET.

If Treasury rates rise, the Federal Reserve portfolio will lose value. Until Dodd-Frank, 90percent of the Fed’s earnings became Treasury receipts, so the Treasury and the taxpayers bear the cost of the recent change. Dodd-Frank authorizes the new consumer agency to sequester Federal Reserve earnings without approval by the Congress or the Fed. I have been told that this off-budget finance is not unconstitutional. I continue to believe that the Congress should prohibit ALL off-budget finance. The constitutional provision that makes Congress responsible for spending should be strengthened.

The question regarding the implications of our enormous debt has several parts. Some ask for more precise answers than anyone can give correctly.

The “tipping point”: Some authors say a ratio of 90 to 100 for government debt to gross domestic product (GDP) is a ceiling. Beyond the ceiling, interest rates rise suddenly because bond investors fear inflation, default, or sharply rising interest rates and losses in the value of bond holdings. We are there. Public debt is \$ 14.7 trillion, and second quarter nominal GDP is \$ 15 trillion. If we add, as we should, to the current US government debt, the promises to pay obligations of Fannie Mae, Freddie Mac, the Federal financing bank and the unfunded liability for Medicare, Medicaid, and Social Security, the debt of the United States government passed the 90 percent ratio years ago. Currently, unfunded debt in the medical programs reaches \$70 to \$100 trillion, as much as 6 or 7 times the reported debt, depending on the rates used to discount future promises. The “full faith and credit of the United States” is stretched far above the ability to pay. Yet interest rates on government bonds are lower than they have ever been. There is no sign in current interest rates of the looming debt problem. Exchange rates tell a different story.

Why wait for a “tipping point” and a crisis? We have ample warning that we are on an unsustainable path. We don’t know when a crisis will occur, and we should

not wait to learn whether it does. PRUDENT POLICY ANTICIPATES CALAMITIES BEFORE THEY OCCUR. RESPONSIBLE POLICY MAKERS DON'T WAIT FOR CRISES.

Japan's outstanding public debt is at least double its GDP. Government debt for Italy and Belgium has long been above 100 percent of GDP. I do not know what unfunded liabilities may add to these sums. They suggest that we will not find a precise number like 90 percent of GDP to warn us of impending interest rate increases. But we also know from the recent experience of Greece and Italy that sudden changes in market perceptions occur. What was acceptable suddenly becomes unacceptable. This is a warning that prudent folks will heed.

Perhaps we should see a warning in the fact that our debt and deficits are unsustainable. Every knowledgeable observer recognizes that. Why wait for a market crisis to tell us what we already know?

At a time of considerable uncertainty about the future of currencies and economies, the large, open market for U.S. debt is a refuge for frightened investors. The Federal Reserve does not let interest rates increase, so holders think they are protected from losses caused by rising interest rates. Some hope for additional gains if the Fed lowers rates by making additional large scale purchases. The result is that for the present holders are willing to accept negative real returns on their bonds. Negative real returns subtract the current inflation rate from the current market interest rate.

Japan's relatively large debt is almost entirely owned by Japanese citizens. Unlike our current citizens, Japanese save and put much of their saving into Japanese institutions that buy government debt. The nominal interest rate on long-term Japanese debt has remained between 1 and 2 percent for many years. Investors expect that pattern to continue, so there is no sign of an impending debt crisis. Japanese experience should not make us sanguine. We depend on the rest of the world to finance at least half our annual budget deficit. That's a risk for us but not for Japan.

Italy is instructive. The debt to GDP ratio remained above 100 percent for years. Italian savers bought a large part of the debt. As concerns about the future of the euro rose, Italian debt suddenly and unexpectedly rose in yield and fell in price. The European Central Bank made large purchases to reassure investors that there was a residual buyer. Uncertainty about what will happen in the future, not the distant future, remains.

German and French banks hold large amounts of Italian debt. They would like a government bailout, so they pressure governments. Meanwhile, they sell as much of the Greek, Italian, and Spanish debt as they can.

The sudden crisis affecting Greece and Italy teaches two things of value to us. One is market perceptions and actions can change quickly. The other is that prudent policy does not wait for the crisis. It acts before when many more options are available. It would be better to adopt Congressman Ryan's budget plan that leaves current and near-term health care beneficiaries unharmed than to wait for a crisis that forces much more immediate, drastic action and harms current recipients.

If rates spike up, without warning, we will be forced to make sharp, sudden changes in spending and tax rates. The alternatives are default and inflation. Default would harm the credit of the United States for years, even decades. It should be unthinkable.

Many now propose to ease the debt burden by raising the inflation rate to 5 or 6 percent. That would reduce the burden of long-term debt and mortgages, but it would raise interest rates for new debt issues and refunding. The average maturity of outstanding debt is between 3 and 4 years, so we would face higher interest rate expense very soon. I would like the proponents of a higher inflation target to tell us how they propose to bring the inflation rate down in the future. It is unlikely that we can reduce inflation without causing a new recession. People invest expecting inflation to continue. Farmers borrow to buy land. Home builders suffer a collapse when disinflation raises interest rates. Moreover inflation will not put much of a dent in the enormous unfunded liability for health care. And it cheats the principal holders of U.S. debt, especially China and Japan, with unforeseen consequences.

Recent unprecedented actions by the Federal Reserve solicit questions about limits to Federal Reserve monetary expansion. There are no legal restrictions. The only limit I know comes from the public. At some inflation rate, the public will demand less inflation. In 1979, inflation reached double digits. The public declared inflation to be the major economic problem. President Carter responded by appointing a known anti-inflationist, Paul Volcker. In his interview, Volcker told the president that he would reduce inflation. President Carter responded that was what he wanted. He had not taken effective action before, but he faced an election in which the public wanted lower inflation.

Increasing inflation until the public responds is not the right answer. One part of the right answer is to reach a long-term budget agreement that brings government spending below sustained GDP growth. That will be difficult but there is much waste in health care and other spending. I will expand a bit if you wish. The other part of the right answer is to rein in the unrestricted power of the Federal Reserve by imposing an inflation target.

And finally, what might be the consequences of adopting stabilizing policies? Ten years from now, we will export more and import relatively less. We will grow family incomes at about our long-term trend. Consumption will grow more slowly than in recent years because we must export more and import less to service the nearly \$ 5 trillion of debt owed to foreigners. Foreigners will have to find a substitute for export-led growth because we can no longer be the importer of last resort. Of major importance for the future is the smaller role we will play in maintaining world peace. The United States cannot be the world's policeman. But political stability is vital. That's a big, separate set of issues that take us far afield.