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IT'S TIME TO REIN IN THE FED

SCOTT FULLWILER and L. RANDALL WRAY

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Preface

In this brief, Scott Fullwiler and Senior Scholar L. Randall Wray review the roles of the Federal Reserve and the Treasury in the context of quantitative easing (QE). They find that the crisis has highlighted the limited oversight of Congress and the limited transparency of the Fed. And since a Fed promise is ultimately a Treasury promise that carries the full faith and credit of the US government, the question is whether the Fed should be able to commit the public purse in times of national crisis.

According to the authors, the Fed has not learned how to efficiently implement monetary policy. QE can only work through price effects, not through quantity, and it is probable that a second round—QE2—could be deflationary. Since fiscal policy is the only possible engine of growth to lead an economic recovery, policymakers must rely on domestic measures to reverse job loss. Otherwise, there is a real danger that the United States will slip back into recession.

When the global financial crisis began in 2007, the Fed provided liquidity and created extraordinary standing facilities, which provided short-term credit in the money markets. The Treasury also intervened to extend funds and guarantees. Though the total amount of government commitments is estimated at more than \$20 trillion, only a very small portion was explicitly approved by Congress.

The Fed's focus on fighting inflation seems to have diverted attention away from its core responsibilities. The crisis demonstrates the wisdom of returning the Fed to its original mission: to pursue a dual mandate of full employment and reasonable price stability, provide an elastic supply of currency and act as lender of last resort to banks, and regulate financial institutions.

The belief that QE encourages banks to lend excess reserves is clearly mistaken. Another fallacy is that banks need excess reserves in order to induce loans to firms and households. Moreover, the stimulative effects of QE are insignificant, since there is no guarantee that market forces will reduce yields based on a particular quantity of Treasuries purchased by the Fed.

The authors disagree with Fed critics who are concerned that QE will lead to inflation and dollar depreciation, and they do

not support the strategy to pressure US trading partners to appreciate their currencies. Rather, the Fed and the Treasury should announce their intention not to depreciate the dollar, and US policymakers should focus on domestic policy measures to end the crisis. In addition, the belief that monetary policy alone can stabilize the US economy is erroneous and dangerous. Monetary policy played a major role in pumping up asset prices, which subsequently collapsed in a speculative bust. Meanwhile, the neglect of fiscal policy generated macroeconomic imbalances—for example, a record level of household indebtedness as borrowing substituted for jobs and income growth.

QE1 mitigated the economic downturn in spite of some ill-conceived spending and tax cuts, say the authors. The major problem was that the stimulus package was too small, and only temporary. They support a larger and more permanent fiscal policy to deal with the recession. The first task of fiscal policy at this time is to reverse job loss. Although their position is at odds with current attempts to reduce the US budget deficit, they note that the deficit is mostly due to collapsing tax revenues, combined with automatic stabilizers such as unemployment compensation. The deficit will decline rapidly when the economy recovers, they say. Thus, reactive policies such as spending cuts and higher taxes during normal deficit expansions would be a mistake.

Another reason to reject undue reliance on monetary policy is the lack of democratic accountability. While the Fed is accountable to Congress, current law does not provide Congress with substantive control of the Fed. There is an inherent conflict between the need for oversight and transparency associated with public spending, and the need for independence and secrecy in formulating monetary policy. The bailouts have been uncoordinated and largely executed in secret—by the Fed. And the massive, mostly off-budget support of Wall Street has proven to be a tremendous barrier to formulating another stimulus package for Main Street.

As always, I welcome your comments.

Dimitri B. Papadimitriou, *President*
April 2011

Mission and Dual Mandate of the Fed

The Federal Reserve System was founded by act of Congress in 1913, with the primary directive to “furnish an elastic currency.” Its mission was expanded in the aftermath of the Great Depression to include responsibility for operating monetary policy in a manner to help stabilize the economy. After World War II, Congress directed the Fed to pursue a dual mandate, long interpreted to mean full employment and reasonable price stability. The Fed was left to decide how to implement policy to achieve these objectives, and has over time experimented with a variety of methods, including interest rate, reserve, and money aggregate targets. While some central banks have adopted explicit inflation targets, the Fed has argued that this would limit its ability to respond in a flexible manner to disruptions, and would not be consistent with its dual mandate. Note also that none of the later amendments to the 1913 act have supplanted the Fed’s original directive to act as lender of last resort or manager of the national payments system, and thus provide an “elastic currency.” Finally, the Fed has always been in charge of regulating and supervising member banks—a responsibility it shares with the Treasury.

When the global financial crisis began in 2007, the Fed reacted by providing liquidity through its discount window and open market operations, later supplemented by a number of extraordinary facilities designed to provide reserves as well as guarantees. The creation of various standing facilities that extended short-term credit to banks, primary dealers, and other money market players was labeled “credit easing” by Chairman Bernanke and others. (Most of the credit extended through these facilities was wound down by late 2009.)

The Treasury also intervened to provide funds and guarantees to the financial (and nonfinancial) sector, in some cases working with the Fed. Some estimates place the total amount in government loans, purchases, and guarantees made during the crisis at more than \$20 trillion—an amount far greater than the value of the nation’s total annual production. Only a very small portion of this funding was explicitly approved by Congress, and much of the detail surrounding commitments made—especially those made by the Fed—is still unknown.

While it is beyond the scope of this paper, it has become clear that inadequate regulation and supervision of financial institutions by the Fed played an important role in the transformation of the financial sector that made this crisis possible. A dangerous philosophy developed over the past several decades that deregulation and self-supervision would increase market

efficiency and allocate risk to those best able to bear it. Time after time, the Fed refused to intervene to quell speculative bubbles, on the theory that the market is always correct. This was made even worse by the Fed’s cultivation of a belief that no matter what goes wrong, it will never allow a “too big to fail” institution to suffer from excessively risky practices. If anything, this encouraged more risk taking.

In recent years, the Fed chose to ignore the growth of systemic risk, focusing instead on managing inflation expectations. Unfortunately, it also put much more weight on inflation outcomes, downplaying its mandate to pursue full employment. This was justified—erroneously, we believe—on the argument that low inflation and low inflation expectations somehow automatically lead to robust economic growth and high employment. In sum, the Fed’s growing focus on inflation fighting seems to have diverted its attention away from its responsibility to regulate and supervise the financial sector, and its mandate to keep unemployment low. This shift in priorities contributed to the conditions that led to this crisis.

It is likely that this shift in priorities to managing inflation expectations also prevented Fed researchers from recognizing the growth of speculative and risky practices. With inflation over the past two decades remaining at moderate levels, the Fed believed its policies were working well. Each time there was a crisis, the agency intervened to minimize disruptions. Markets coined a term—the Greenspan “put”—and elevated the Fed chairman to “maestro” status. While many economists outside the Fed did “see it coming,” and while they continually questioned the wisdom of allowing serial speculative bubbles in equity, real estate, and commodity markets, Fed researchers and policymakers largely dismissed these warnings. Markets also frequently recognized the risks, but presumed that the Fed would bail them out in case of crisis. When policymakers view their role as one of ignoring systemic risk while promising rescue, they are effectively serving as cheerleaders for bubbles, manias, and crashes. This is a dangerous mix, one bound to result in catastrophe.

In conclusion, the current crisis demonstrates the wisdom of returning the Fed to its original mission, as amended over the years by Congress:

- to act as lender of last resort, providing an elastic supply of currency to banks as necessary to quell a liquidity crisis;
- to regulate and closely supervise financial institutions, to ensure safety and soundness of the financial system; this

includes the use of margin requirements and other means to prevent financial institutions from fueling speculative bubbles, and resolving insolvent institutions rather than adopting a policy of “too big to fail” that promotes and rewards reckless behavior; and

- to pursue the dual mandate of full employment and reasonable price stability.

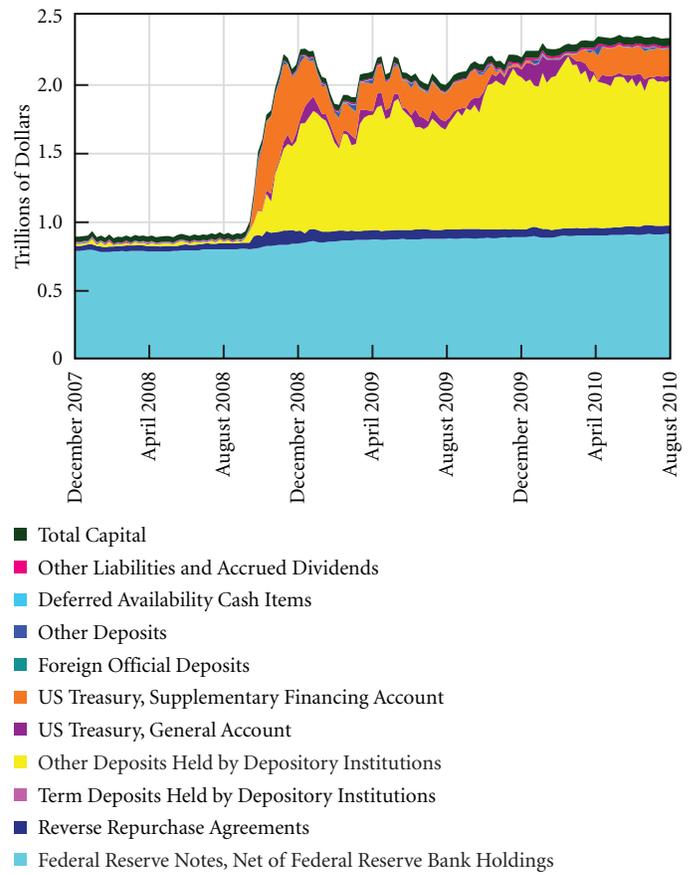
Quantitative Easing: Implementation and Impacts

Chairman Bernanke has long held that a central bank can continue to provide economic stimulus even after it has pushed short-term interest rates near the zero lower bound. This was his recommendation for Japan, which has held rates at or near zero for a dozen years but remained mired in a downturn, with deflation of asset and consumer prices. Before joining the Fed, Professor Bernanke promoted “quantitative easing,” a policy of asset purchases by the central bank to create excess reserves in the banking system. Since excess reserves earn little or no interest, banks would be induced to make loans to earn more interest. This, he argued, would encourage spending to create the stimulus required for growth and job creation.

After pushing the federal funds rate target close to zero (0–25 basis points in December 2008), the Fed began to pursue its first phase of quantitative easing (QE1), a new monetary policy distinct from the “credit easing” that characterized the period immediately following the onset of the crisis. In March 2009, the Fed announced plans to increase its total purchases to \$1.75 trillion. These purchases—housing agency securities as well as longer-term US Treasuries—generally replaced the assets acquired from standing facilities implemented during credit easing, as most of the credits were wound down and sustained the more than doubling of the Fed’s balance sheet that occurred under credit easing (Figures 1 and 2). By March 2010, it had bought more than a fifth of the outstanding stock of longer-term agency debt, fixed-rate mortgage-backed agency securities, and Treasury securities. Purchases were handled by the Federal Reserve Bank of New York, which hired external investment managers (BlackRock, Goldman Sachs, PIMCO, Wellington, and JPMorgan Chase were hired to provide various services).

Unlike typical open market operations, which are conducted to accommodate banks’ desired reserve balances at the Fed’s target rate while minimizing impacts on the prices and yields of the assets purchased, QE1 was designed to lower yields on longer-

Figure 1 Federal Reserve Bank Liabilities, December 2007 – August 2010 (in trillions of dollars)

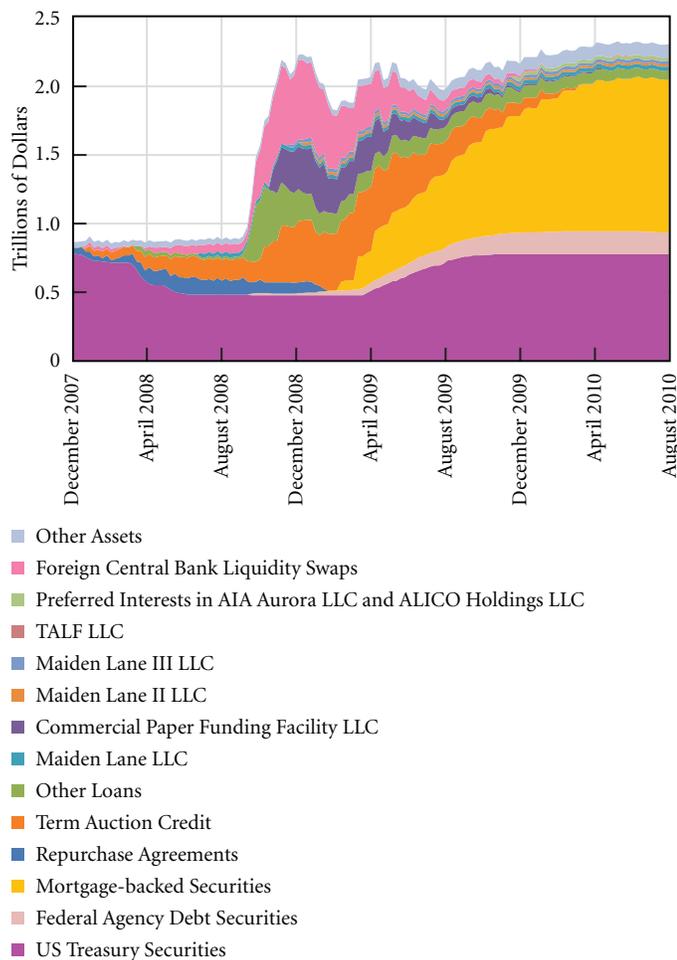


Source: Federal Reserve Board of Governors

term assets. The goal was similar to that of “Operation Twist” from the early 1960s: lower the long-term interest rate relative to the short-term rate (which was already near zero when QE1 began). According to a detailed staff study by the New York Fed, the Federal Reserve’s \$1.75 trillion in purchases lowered the term premium by as much as 52 basis points (that is, half a percentage point; using alternative methodologies, the estimated reduction falls within a range of 38–82 basis points) (Gagnon et al. 2010).

Chairman Bernanke has recently announced that a new round of quantitative easing (QE2) will entail purchasing an additional \$600 billion in Treasuries. Extrapolating from the New York Fed’s study, this could be expected to lower long-term yields by another 18 basis points. However, impacts on interest rates on private debt resulting from QE2 will probably be less because, unlike QE1, the Fed plans to buy government debt rather than mortgage-related debt. Hence, we expect longer-term rates on

Figure 2 Federal Reserve Bank (Select) Assets, December 2007 – August 2010 (in trillions of dollars)



Source: Federal Reserve Board of Governors

private borrowing (such as fixed-rate mortgages) to fall by less than 18 basis points.

Those who believe that QE works by filling banks with more reserves than they want to hold, thus encouraging them to lend out the excess, are clearly mistaken. First, banks do not and cannot lend reserves to firms or households. Reserves are equivalent to a bank’s checking account at the Fed, and it can only lend to other institutions that also hold reserves at the Fed. Banks do lend reserves to one another in the Fed funds market, but since there is already more than \$1 trillion dollars in excess reserves in the system, there is no need to give them more in order to encourage them to lend to one another.

The other fallacious argument is that banks need excess reserves to induce them to make loans to firms and households.

There are three relevant counterarguments. First, in normal times banks make loans and then obtain the reserves that are required for clearing or to be held against deposits. They first go to the Fed funds market to borrow reserves; if there are no excess reserves in the system as a whole, the Fed funds rate is bid up. Because the Fed operates with a rate target, it will intervene to supply the banks with reserves when the actual rate exceeds the Fed’s tolerance for deviation from its target. Second, given that banks already have \$1 trillion in excess reserves, adding more reserves will not increase their inducement to make loans—if they want to make loans, they have enough in excess reserves to cover literally trillions of dollars in new loans and deposits. Finally—and this is a point to which we return below—the US private sector is already suffering from excessive debt (indeed, that was one of the factors that contributed to the crisis). It makes little sense to encourage more lending and borrowing in a condition of national overindebtedness.

Still others believe that the “cash” created by QE2 will create more spending. That is, as the Fed purchases Treasuries from households or firms, these entities will now have a deposit on the asset side of their balance sheet where the Treasuries once were. Of course, any individual holding a Treasury security who wanted a deposit instead could sell the security at any time, with or without QE2. The only difference is that with QE2, it may be sold at a higher price. And, as with bank reserves, deposits do not increase a bank’s ability to create loans; a bank makes a loan by creating a demand deposit. In fact, Treasuries themselves are the best form of collateral and are routinely leveraged several times over in repurchase markets, in the process providing their owners some of the lowest-cost financing available.

Thus, whether one wants to focus on bank reserves or on the deposits created by QE2, QE2 does not confer an “ability” to create loans or spend that did not exist before. In both cases, the effect of QE2 is to replace a longer-dated Treasury with shorter-term investments in private portfolios, which on balance reduces income received by the private sector (as we explain below). An increase in spending would depend on whether the private sector wished to borrow more or to reduce saving out of current income (things they can do anyway with or without QE2). Again, it makes little sense to encourage households and firms to increase debt or reduce saving within the current context of record private sector debt.

If QE is to work, it is not through *quantity* but rather through *price effects*. Providing excess reserves serves to push the

Fed funds rate down. But since the Fed now pays 25 basis points on reserves, it is not possible to push the average rate below 25 basis points (since a profit-seeking bank will not lend reserves at a rate lower than what the Fed pays). However, by purchasing longer-term assets, the Fed can drive that rate down toward the 25-basis-point minimum. Competitive pressures can then lower other rates—such as the rate banks charge on commercial and mortgage loans. This is how QE could stimulate the economy. But, as demonstrated by the New York Fed’s study, the impact of QE2 on interest rates will not be large; even interest rates on US Treasuries will fall only marginally. And if we presume that reducing the rate on long-term Treasuries by 18 basis points (based on the New York Fed’s estimate) were to carry through to private lending rates, then the impact on private spending would be trivial. To be sure, there is a great deal of controversy about the interest rate elasticity of spending (i.e., how responsive spending is to changes of the interest rate). But even taking the highest estimates and most optimistic scenario into account, the stimulative effect of QE2 on the types of spending thought to be responsive to long-term interest rates would be insignificant.

Indeed, since the announcement of QE2, Treasury rates have actually risen slightly. This again demonstrates the importance of understanding that the Fed’s operations are about price, not quantity. If the Fed wanted Treasury rates to decline, it could only be sure of achieving this goal by announcing the desired rate and standing ready to buy all Treasuries offered at the corresponding price. While this might require the Fed to buy more than the announced \$600 billion in QE2 funds (or it might not, in fact), it would demonstrate that the Fed clearly understood its own operations. Announcing a *quantity* target (\$600 billion) is not an effective way to lower yields, since the Fed will pay a market-determined price to achieve that goal, and there is no guarantee that market forces will lead to any reduction in yields with that particular quantity of Treasuries purchased by the Fed.

If the Fed instead announced a *price* target (corresponding, say, to a yield of 2 percent on 10-year bonds), the market would quickly move yields toward that target, for the simple reason that it knows the Fed is able to purchase enough Treasuries to achieve the target. The Fed’s operation of QE2 is similar to its earlier operation of “credit easing” during the liquidity crisis: it focused on the quantity of reserves to be supplied (e.g., through auctions) rather than on the price (setting a Fed funds target and then lending at that rate without limit, as a lender of last resort to all financial institutions). Unfortunately, the Fed still has not

learned how to efficiently implement monetary policy in order to achieve the desired result of lowering interest rates. Indeed, even the name of the policy, *quantitative* easing, indicates that the Fed does not fully understand what it is trying to accomplish.

Finally, if we consider the possible negative impact on income and spending resulting from lower interest income on savings, a plausible case can be made that QE2 will actually be deflationary if it succeeds in lowering rates. Since QE2 targets Treasuries, its greatest impact will be on Treasury yields, which provide interest income to the nongovernment sector (households, firms, not-for-profits, pension funds, and so on). Yields are already unusually low, having fallen on average by nearly five percentage points at the short end of the yield curve and almost two percentage points at the longer end of the yield curve since the financial crisis began in August 2007. This has resulted in less consumption by those who rely on government interest payments, such as retirees. Lower interest rates in turn encourage savers to reduce consumption to the extent that they have savings growth targets for retirement, college funds for their children, and other financial goals.

In sum, it is probable that QE2 will not provide much economic stimulus; indeed, we cannot be sure that QE2 will be stimulative at all, and there is even some possibility that it will *reduce* income and spending.

QE and Its Critics

While some critics have likened QE to “helicopter drops of money,” that clearly is not taking place. Particularly in the case of QE2, the Fed’s actions merely replace Treasuries with reserves. While that might have minimal impact on interest rates, it will not induce much spending. Further, the current pressures on the economy are overwhelmingly deflationary, and QE2 could even add to deflationary impacts due to its effect on interest income.

Recognizing this, some critics argue that today’s policy will cause inflation in the future because QE will leave banks with massive quantities of reserves. Yet the Fed can and will reverse course if inflation pressures build. When the economy recovers, and if there are signs of inflation, the Fed will begin to push up short-term interest rates (as it has done for decades whenever there were signs of inflation). It will also begin to drain excess reserves from banks by unwinding its own portfolio. It will accomplish this by selling its assets back into the banking system: for each bond sale the Fed makes, it will debit bank reserves

dollar for dollar. If desired, it can do this at a measured pace, so that these sales need not affect yields. Or it can proceed more quickly, selling assets at a pace sufficient to push prices down (and yields up). The process will continue until banks hold no excess reserves.

From our discussion of interest rate elasticities, it is clear that we doubt such actions have a decisive impact on aggregate spending; we wish only to emphasize that the existence of more than \$1 trillion in excess reserves in the banking system will pose no challenge to policymakers when they decide to reverse QE and raise interest rates to fight perceived inflation pressures. It should also be clear that we are not supporters of QE; rather, we believe that the inflation argument is entirely erroneous. Anyone making that argument simply does not understand monetary operations. Finally, given that the quantity of reserves banks hold has no impact on their ability to create loans or to otherwise finance economic activity, there is in fact little economic necessity for the Fed to drain excess reserves even if inflation pressures do build. The Fed is perfectly able to raise the Fed funds rate target even in the presence of massive excess reserves, given that the target rate is now set equal to the rate paid on excess reserves held by banks. All the Fed needs to do is to bring the rate it pays in line with the increase in its target rate, forcing up market rates on overnight funds.

There have also been negative reactions, especially from abroad, by those who fear that QE will cause the dollar to depreciate. Following our discussion above, there is little justification for such fear. QE will have minimal effects on long-term interest rates and domestic spending. Hence, there is little reason to believe that it will have direct impacts on capital flows or current account deficits.

To be sure, exchange rates are complexly determined and no economic model has proven successful at forecasting their movements. If QE has any impact on the value of the dollar, it is likely to come through its effect on expectations. Ultimately, expectations must be grounded in something, and if QE has as little impact on the US economy as we believe to be the case, then there are no grounds for believing exchange rates will shift. But announcements by US policymakers can have at least temporary impacts.

We do wish that the Fed and Treasury would issue an announcement that US policymakers do not intend to depreciate the dollar. We believe that all of the pressure Treasury Secretary Geithner is putting on some of our trading partners to

appreciate their currencies is a mistake, since it is tantamount to arguing that the US government *wants* the dollar to depreciate. The rest of the world views this as our intention to export our way out of crisis—that is, by adopting a modern mercantilist policy. Such a strategy is not in the interest of the United States (it would raise the cost of imports), nor would it be successful (it would almost certainly lead to retaliatory measures). Many historians believe that the Great Depression was worsened by exactly such a strategy. US policymakers must instead look to domestic policy measures to end this crisis.

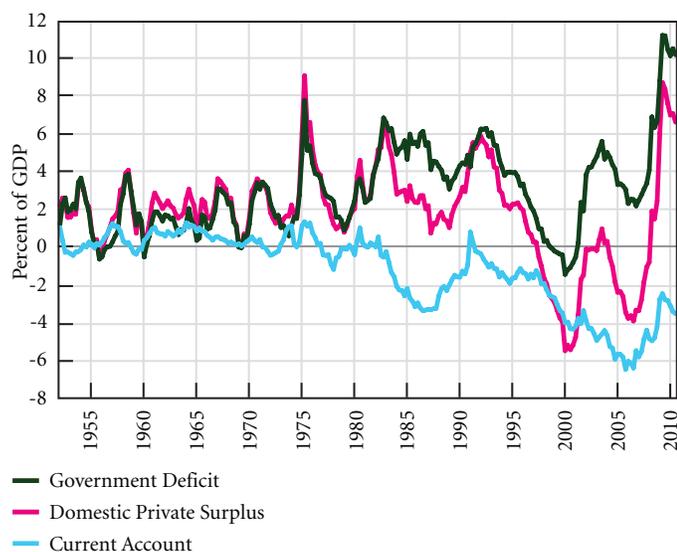
Relative Potency of Monetary and Fiscal Policy

Over the past several decades, many economists and policymakers have adopted the erroneous view that monetary policy, almost alone, can be relied upon to stabilize the economy. Further, it was believed that monetary policy means macro policy—control of the money supply, interest rates, or inflation—thus leaving the financial sector to self-regulation by some sort of “invisible hand” of self-interest. Current events demonstrate both of these beliefs to be dangerously incorrect. It was precisely the absence of close regulation and supervision of financial markets that created the most devastating financial crisis since the 1930s (by no coincidence, the last time that policymakers relied on “free markets” in the financial sector, with virtually no use of fiscal policy to stabilize the economy). And it was the relative neglect of an active role for fiscal policy over the past few decades that generated macroeconomic imbalances—for example, record levels of household indebtedness as borrowing substituted for jobs and income growth.

There was a long-term evolution in macroeconomic thought away from the sensible postwar position that “you can’t push on a string” (the idea that in the presence of pessimistic expectations, lowering interest rates through monetary easing would not encourage spending) and toward the view that the Fed could control the macroeconomy simply by managing expectations. Ironically, this transition occurred even as macro performance suffered, with more frequent and severe crises that were often caused by “bubble and bust” cycles in financial markets.

It is also important to recognize that monetary policy “works” only if it can alter the private sector’s preference for debt over saving out of current income. That is, adjusting interest rates up or down can only affect the economy if the private sector then decides to borrow less or more. Similarly, even if QE did

Figure 3 Sector Financial Balances, 1952Q1 to 2010Q3 (in percent of GDP)



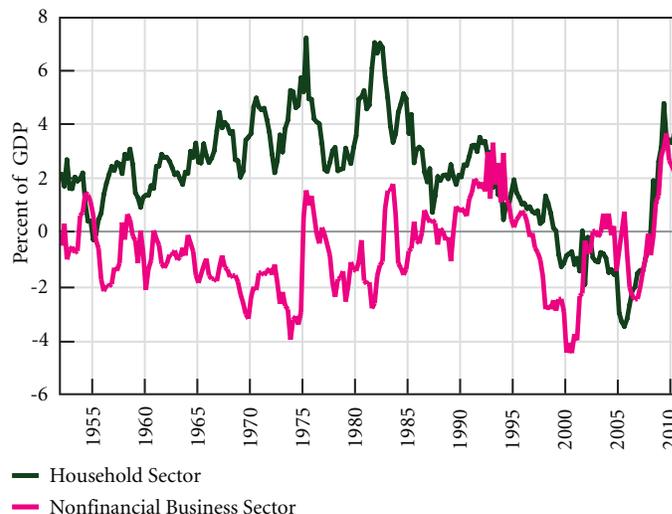
Sources: National Income and Product Accounts, Flow of Funds, and authors' calculations

work as both its proponents and some critics insist, it would only be through encouraging the private sector to spend more out of its existing income—which, again, is a highly questionable strategy in a deep recession where the private sector is (rationally) trying to deleverage.

Consequently, a strong case can be made that, while monetary policy is relatively impotent when it comes to stabilizing our real, productive economy, it has played a big role in pumping up asset prices that then collapse in a speculative bust. Meanwhile, our monetary policymakers have chosen to leave the financial sector largely unregulated and unsupervised. That is, they have refused to exercise their authority in the one area over which they do have substantial control: regulation and supervision of financial institutions.

Instead, monetary policymakers have pursued macro policy on the highly dubious claim that they can fine-tune the economy—which is more than a little ironic, since their own approach is strongly grounded in a critique of so-called Keynesian “fine-tuning.” Yet every tool and target that they have chosen has failed in that task, from the reserves and money targets of Chairman Volcker, to the interest rate target of Chairman Greenspan, to the expectations management of Chairman Bernanke. None of these initiatives have given us sustainable

Figure 4 Household and Nonfinancial Business Net Saving, 1952Q1–2010Q3 (in percent of GDP)



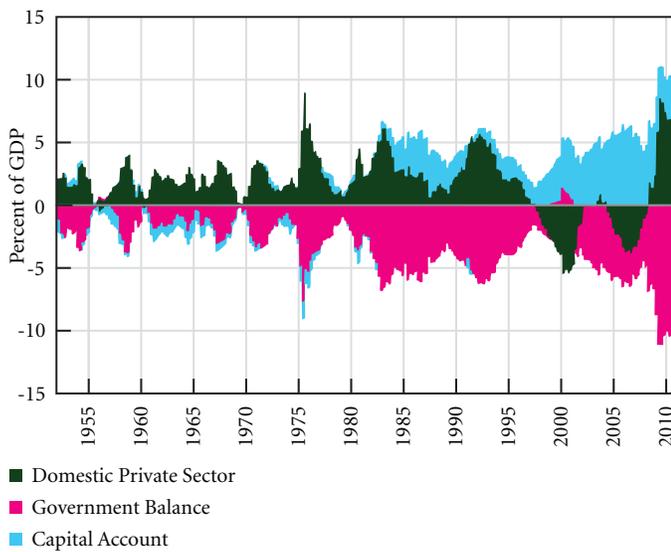
Sources: National Income and Product Accounts, Flow of Funds, and authors' calculations

growth, sustainable job creation, or sustainable, rising living standards.

Indeed, incomes stopped growing for most American workers as we downgraded the role of fiscal policy in favor of monetary policy: for more than a generation, there has been no appreciable increase in median real wages. Even at business cycle peaks, tens of millions of potential workers have been left behind—unemployed or involuntarily out of the labor force—and in recessions their ranks have swelled by millions more (Pigeon and Wray 1998). Our nation’s infrastructure has been allowed to deteriorate as much of the rest of the world caught up with our living standards, and in some respects surpassed them. While the United States has technologically advanced sectors, we have fallen behind in many areas that matter for working people—such as modern public transportation, access to decent health care, and high-quality education for most. All of these are areas that cannot be stimulated by even well-formulated monetary policy. These are the responsibilities of fiscal policy, and they have been neglected on the unfounded belief that monetary policy alone is enough.

In a deep recession and financial crisis, well-formulated fiscal policy is a necessity. Its first task must be to reverse job loss. While policy should help the private sector, given depressed expectations private employers cannot be expected to carry the

Figure 5 Sector Financial Balances, 1952Q1 to 2010Q3 (in percent of GDP)

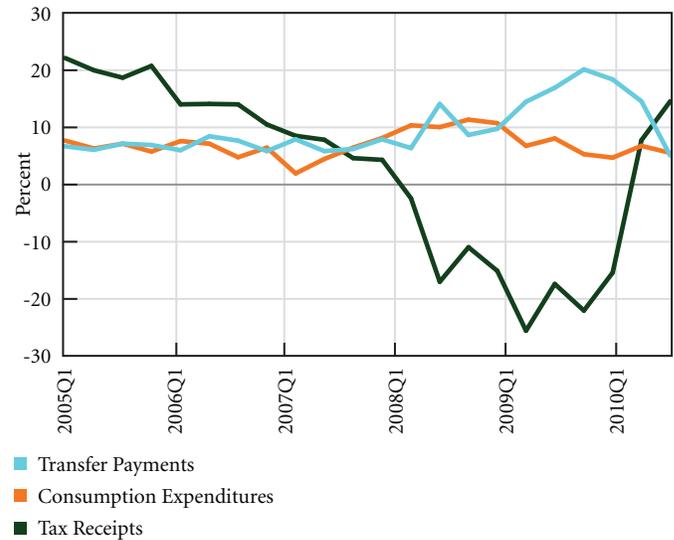


Sources: National Income and Product Accounts, Flow of Funds, and authors' calculations

entire burden. They will increase hiring only as economic conditions improve—no matter how many tax breaks we give them, they will not increase employment until sales increase. American households are already overburdened with debt, so we cannot wait for them to decide to increase their spending; they are rationally cutting back, trying to strengthen their balance sheets by saving. Since the end of 2006, the total swing of the domestic private sector balance—from large deficits (spending more than income) to a substantial surplus)—has been more than 10 percent of GDP (Figures 3, 4, and 5). That is a “demand gap” of 10 percent of GDP that must be made up by either the government sector or the external sector. If the United States were a small exporting nation, it could conceivably rely on export growth to create the demand necessary to generate recovery. Clearly, that is not the case: the United States’ economy is much larger than that of any other nation, and its role as provider of the international reserve currency makes it unlikely that export-led growth will bring recovery. That leaves fiscal policy as the only possible engine of growth.

There has been a lot of debate about the success of the \$800 billion-plus stimulus packages, with some claiming that fiscal stimulus failed to generate economic recovery. Yet all reasonable analyses have found that it prevented the economy from falling

Figure 6 Federal Government Receipts and Expenditures, 2005Q1–2010Q2 (quarter on quarter change in percent)



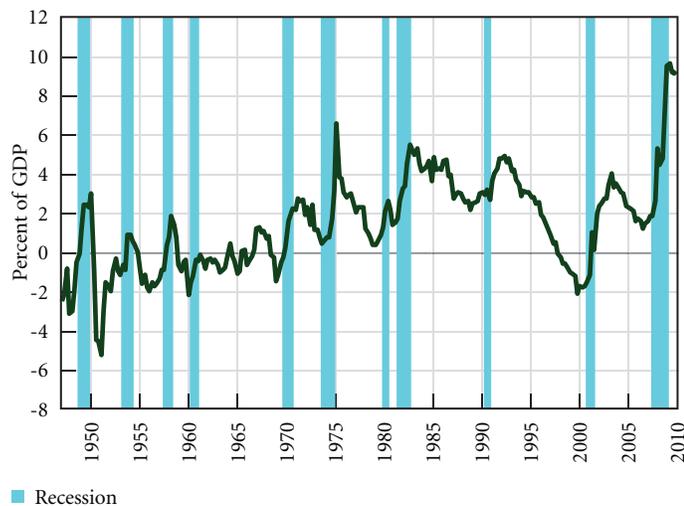
Note: Tax receipt data are unavailable for 2009Q4.

Source: Bureau of Economic Analysis and authors' calculations

farther than it did. While some of the spending and tax cuts may have been ill conceived, the major problems with the stimulus packages were that they were too small, and only temporary. Indeed, as the stimulus came to an end, evidence of economic weakening began to appear. Nowhere is this more obvious than in the finances of state and local governments, with budget cuts and employee layoffs continuing. It is inconceivable that this will not negatively affect businesses and households in coming months. As public employees lose their jobs, it will impact the already depressed real estate markets in multiple ways. America is in real danger of slipping back into recession.

What was needed was a larger and more permanent fiscal policy to deal not only with the recession but also with the areas of our economy that have long been neglected. We realize that our position is at odds with the current attempt to reduce the budget deficit. We note, however, that our currently large deficit is primarily due to collapsing tax revenues (Figure 6), and secondarily, to the growth of transfer spending (mostly unemployment compensation)—both of which are a result of the economic downturn. The budget outcome of the federal government is largely determined by economic performance: deficits rise in a recession and the budget moves toward balance, or even surplus, in an expansion (Figure 7). The cyclical nature

Figure 7 Federal Government Balance and Recessions, 1947–2010 (in percent of GDP)



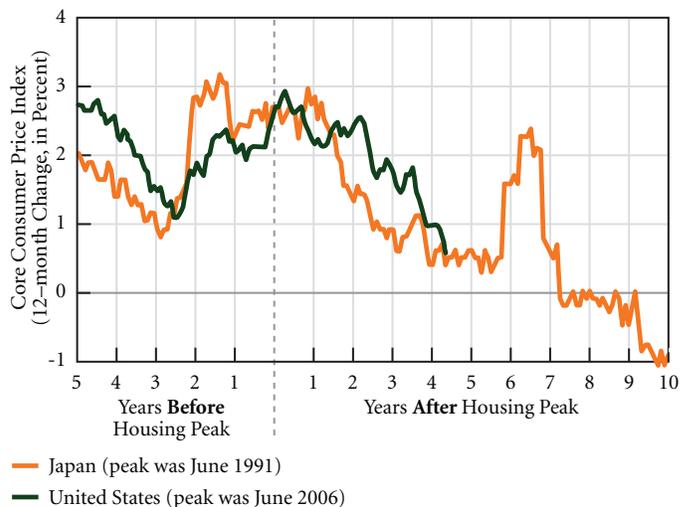
Note: The sign of the deficit/surplus is reversed.

Sources: Bureau of Economic Analysis and National Bureau of Economic Research

of the budget is a function of the automatic stabilizers rather than discretionary policy. This is a desired feature of a national government budget, not a design flaw. Reacting to the normal expansion of deficits with policies that cut spending or increase taxes would be a mistake.

Most of those who are proposing that we tackle the budget deficit realize this, and hence are focused on deficit cutting once recovery is under way. Yet experience over the past several business-cycle swings shows that, if anything, the budget is excessively biased toward tightening in a robust expansion. In the last two growth cycles (neither of which achieved full employment of our nation’s resources), federal tax revenues grew at an unsustainably high pace—15 percent per year and even more. This was two or three times faster than GDP. This means that if we were to achieve and maintain full employment, the budget deficit would quickly disappear. And that was precisely the experience during the latter half of the 1990s, when a budget surplus was last achieved. We do not wish to be misinterpreted: we are not advocating a balanced budget, much less a budget surplus, as a desired outcome. We are merely arguing that there is no reason to believe that the federal budget stance is too “loose”—that is, biased to run deficits at full employment. We think the evidence

Figure 8 Following Japan’s Path, So Far



Note: In the United States, the core consumer price index (CPI), which excludes food and energy prices, rose 0.6 percent in the 12 months ending October 31, 2010. That was the smallest 12-month gain since the government began calculating the figure in the 1950s. The chart shows the 12-month changes in core CPI for the United States and Japan, in the years before and after housing prices peaked in each country.

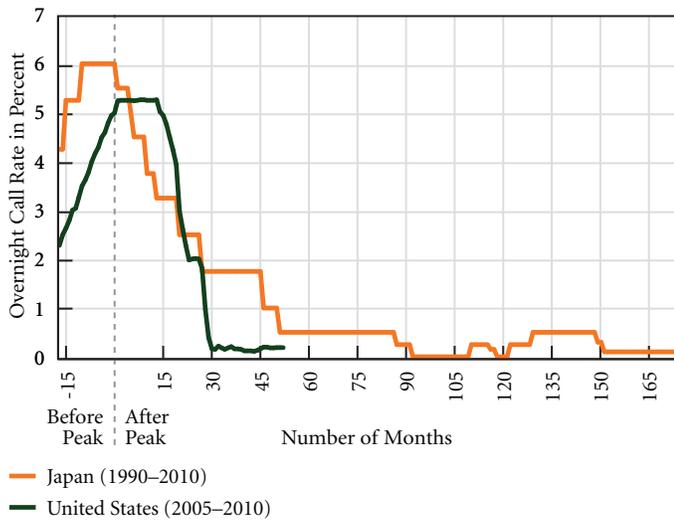
Sources: US Bureau of Labor Statistics; Japanese Ministry of Internal Affairs and Communications, via Haver Analytics

shows precisely the reverse. If the economy recovers, the deficit will rapidly shrink.

As to the longer-term deficits that supposedly will be generated by excessively generous “entitlements” (Medicare and Social Security), we think the debate has run seriously astray, courtesy of Blackstone chief Pete Peterson’s hedge fund billions. But that is a topic beyond the scope of this paper.

There are similarities between our financial crisis and economic downturn and the Japanese experience over the past two decades. Japan also had a tremendous real estate boom that subsequently collapsed. Figures 8, 9, and 10 superimpose Japanese data on inflation, interest rates, and budget deficits over the same data for the United States. We have shifted the time period to make the performance over the crises comparable. What we see so far is that the United States has been tracking Japan’s performance on all these variables to a remarkable degree. Japan, too, mostly relied on monetary policy. Expansion of its budget deficit was mostly due to poor economic performance. While it did try some limited stimulus packages, it always ended fiscal stimulus before the economic recovery was sustained (often by

Figure 9 US Federal Funds Rate and Japan Overnight Call Rate, before and after Housing Peak (in months)



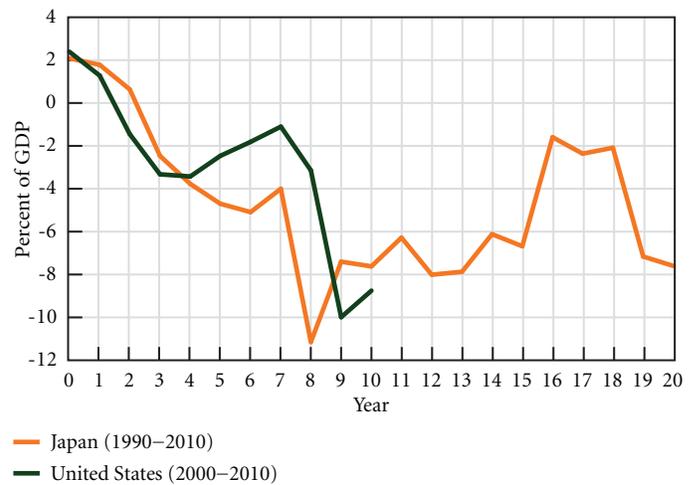
Sources: Bank of Japan and Federal Reserve Bank of St. Louis Economic Database

raising consumption taxes). The monetary policy ease never stopped the deflationary cycle, and real estate prices continue on their downward trend today. We do not insist that Japan’s 20-year-long nightmare is coming to America, but these charts should prompt policymakers to consider a more aggressive response, and one that will not exclude a greater role for sustained fiscal policy stimulus.

Democratic Accountability and Transparency of the Fed

There is an additional reason to reject undue reliance on monetary policy to the exclusion of fiscal policy: those in charge of monetary policy are not subject to the same degree of democratic accountability. Further, while the Fed’s actions have become more transparent since 1994 (when Representative Gonzalez caught Chairman Greenspan in a subterfuge, leading the agency to substantially reduce its secrecy in response to congressional demands), most of its deliberation remains behind closed doors. At best, it informs Congress of its decisions after the fact. We still do not know exactly what Timothy Geithner did as president of the New York Fed. He has never revealed the full extent of the promises made to private financial institutions, and we do not have a full accounting of all the purchases and deals

Figure 10 Deficits in Japan and the United States (in percent of GDP)



Sources: Organisation for Economic Co-operation and Development and Federal Reserve Bank of St. Louis Economic Database

made. Fed officials are not elected, and by design they are not subject to the will of the voters. While the Fed is a creature of Congress, current law does not provide substantive control. In this section we will explore, in particular, the issues raised by a too heavy reliance on the Fed, rather than on the fiscal authorities, to deal with financial and economic crises.

Since 2007, the Federal Reserve Bank has mounted an unprecedented effort to stabilize the financial system and the national economy. Faced with the worst crisis since the Great Depression, the Fed found that traditional monetary policy—lowering interest rates and standing by as lender of last resort to the regulated banking system—was impotent in the face of collapsing asset prices and frozen financial markets. The Fed created an “alphabet soup” of new facilities to provide liquidity to markets. It worked behind the scenes to bail out troubled institutions. It provided guarantees for private liabilities. It extended loans to foreign institutions, including central banks. And as a result, its on-balance-sheet liabilities grew to \$2 trillion, while its off-balance-sheet contingent promises amounted to many trillions more.

Congress and the public at large have grown increasingly concerned by the size of these commitments and the shroud of secrecy surrounding actions taken by the Fed. For the most part, the Fed has refused requests for greater transparency. Ironically,

when the crisis first hit, Treasury Secretary Henry Paulson submitted to Congress a vague request for rescue funds that was rejected precisely because it lacked both specifics and a mechanism to give Congress oversight on the spending. Eventually, a detailed stimulus package that totaled nearly \$800 billion was approved. Yet the Fed has spent, lent, or promised untold trillions of dollars—far more dollars than Congress provided to the Treasury. Most of this has been negotiated behind closed doors, often at the New York Fed. The Fed’s defense is that such secrecy is needed to prevent a run on troubled institutions, which would only increase the government’s costs of resolution. There is, of course, a legitimate reason to fear sparking a panic.

Yet, when relative calm returned to financial markets, the Fed still resisted requests to explain its actions even *ex post*. This finally led Congress, in a nearly unanimous vote, to call for an audit of the Fed’s books. Members of both houses are now questioning the legitimacy of the agency’s independence. In particular, there are concerns that the Federal Reserve Bank of New York is too close to the Wall Street banks that it is supposed to oversee, and that it has in many cases been forced to rescue. The head of the New York Fed met frequently with the top management of Wall Street institutions throughout the crisis, and reportedly pushed deals that favored one institution over another. Like the other district bank presidents, the president of the New York Fed is an appointee—one chosen by representatives of Federal Reserve member banks. This has led critics to call for a rule change allowing such appointments to be by the President of the United States. And while the Fed has become much more open since the early 1990s, the crisis has highlighted how little oversight the legislative and executive branches have over its operations, and how little transparency there is even today.

There is an inherent conflict between the need for transparency and oversight when public spending is involved, and the need for independence and secrecy in formulating monetary policy and in supervising regulated financial institutions. A democratic government cannot formulate its budget in secrecy. Except when it comes to national defense, budgetary policy must be openly debated and all spending subject to open audits. That is exactly what was done in the case of the fiscal stimulus package.

However, it is argued that monetary policy cannot be formulated in the open—for example, a long and drawn-out open debate by the Federal Open Market Committee about when and by how much interest rates ought to be raised would generate chaos in financial markets. Similarly, an open discussion by

regulators about which financial institutions might be insolvent would guarantee a run out of their liabilities and force a government take-over. Even if these arguments are overstated, and even if a bit more transparency could be allowed in such deliberations by the Fed, it is clear that the normal operations of a central bank will involve more closed-door discussion than is expected of the federal budgetary process. Further, even if the governance of the Fed were to be substantially reformed to allow for presidential appointments of all top officials, the need for closed deliberations would not be reduced.

The question is whether the Fed should be able to reach into the public purse in times of national crisis. Was it appropriate for the Fed to commit Uncle Sam to trillions of dollars of funds to bail out US financial institutions, as well as foreign institutions and governments (through repo operations with foreign central banks that lent dollars to them, exposing the Fed to default risk)? When Chairman Bernanke was grilled in Congress about whether it was “taxpayer money” that he had committed, he responded no—it was simply a series of balance-sheet entries. While there is an element of truth in his response, it is also highly misleading. There is no difference between a Treasury guarantee of a private liability and a Fed guarantee. If the Fed buys an asset (say, a mortgage-backed security) by “crediting a balance sheet,” it is no different from the Treasury buying an asset by “crediting a balance sheet.” The impact on Uncle Sam’s balance sheet is the same in either case: it is the creation, in dollars, of government liabilities, and it leaves the government holding some asset that could carry default risk.

The Fed does keep a separate balance sheet and normally runs a profit (its assets earn more than it pays on its liabilities). Profits on Fed equity above 6 percent are turned over to the Treasury. If as a result of its bailout activities the Fed’s profitability is diminished, the Treasury’s revenues will suffer. If the Fed were to accumulate massive losses, the Treasury would have to bail it out, with Congress budgeting for the losses. We are not projecting that this will be the case but merely pointing out that, in practice, the Fed’s promises are ultimately Uncle Sam’s promises, and they are made without the approval of Congress—and in some cases, even without its knowing about them months after the fact. Nor are we implying that Uncle Sam would be unable to keep such promises. There is no default risk on federal government debt, and the government can afford to meet any and all commitments it makes. Rather, we are simply emphasizing that a Fed promise is ultimately a Treasury promise that

carries the full faith and credit of the United States. Our question is one of accountability: should the Fed be able to make these commitments behind closed doors, without the consent of Congress?

Some will object that there is a fundamental difference between spending by the Fed and spending by the Treasury. The Fed's actions are limited to purchasing financial assets, lending against collateral, and guaranteeing private liabilities. While the Treasury also operates some lending programs and guarantees private liabilities (e.g., through the FDIC and Sallie Mae programs), and while it has purchased private equities in recent bailouts (of GM, for example), most of its spending takes the form of transfer payments and purchases of real output. Yet, when the Treasury engages in lending or guarantees, its funds must be approved by Congress. The Fed faces no such budgetary constraint.

Further, when the Treasury provides a transfer payment to a Social Security recipient, a credit to the recipient's bank account is created (and the bank's reserves are credited for the same amount). If the Fed were to buy a private financial asset from that same retiree (say, a security), the retiree's bank account (and the bank's reserves) would be credited in exactly the same manner. In the first case, Congress had approved the payment to the Social Security beneficiary; in the second case, no congressional approval was obtained. While these two operations are likely to lead to very different outcomes (the Social Security recipient's income has risen and he/she is likely to spend the receipt; the sale of a security simply increases the seller's liquidity rather than his/her income, and may not induce spending by the seller), so far as committing Uncle Sam they are equivalent, since each leads to the creation of a bank deposit as well as bank reserves that are a government liability.

There is a difference in the impact on the federal government's reported budget, however: spending by the Treasury that is not offset by tax revenue will lead to a reported budget deficit and (normally) to an increase in the outstanding government debt stock. By contrast, purchases or loans by the Fed lead to an increase in outstanding bank reserves (an IOU of the Fed) that is not counted as part of deficit spending or as government debt (assuming there is ultimately no default on assets purchased by the Fed). (The details of all this are complicated, and there can be knock-on effects that complicate matters further.) While this could be seen as an advantage because it effectively keeps a bailout "off the books," it comes at the cost of reduced account-

ability and less democratic deliberation. This is unfortunate, since operationally there is no difference between a bailout that is taken "on the books" by the Treasury (thus following normal budgeting procedure) and one that is undertaken off the books by the Fed (and thus largely unaccountable).

Bailouts necessarily result in winners and losers, and the socialization of losses. At the end of the 1980s, when it became necessary to resolve the thrift industry, Congress created an authority (the Resolution Trust Corporation) and budgeted funds for the resolution. It was recognized that losses would be socialized, with a final accounting in the neighborhood of \$200 billion. Government officials involved in the resolution were held accountable for their actions, and more than one thousand thrift officers went to prison. While undoubtedly imperfect, the resolution was properly funded, implemented, and managed through to completion.

By contrast, the bailouts in this much more serious crisis have so far been uncoordinated, mostly off budget, and done largely in secret—and mostly by the Fed. There were exceptions, of course. There was a spirited public debate about whether the government ought to rescue the auto industry. In the end, funds were budgeted and the government took an equity share and an active role in the decision making, openly picking winners and losers. Again, the rescue was imperfect, but today, it seems to have been successful. Whether it will still look successful a decade from now we cannot know, but at least we do know that Congress decided the industry was worth saving as a matter of public policy.

No such public debate occurred in the case of, say, Goldman Sachs—which was apparently saved by a series of indirect measures by the Fed (which, for example, provided funds to AIG that were immediately and secretly passed through to Goldman). There was never any public discussion of the need to rescue Goldman through the back-door means of funding AIG; indeed, those actions were discovered only after the fact. The main public justification for rescuing financial institutions has been the supposed need to "get credit flowing again," but if so, the bailouts have been largely unsuccessful (given debt loads in the private sector, encouraging lending is probably unwise in any case). Alternative methods of stimulating credit, or—better—of stimulating private spending, have hardly been discussed.

Indeed, the massive sums already provided to Wall Street (again, mostly off budget) prove to be a tremendous barrier to formulating another stimulus package for Main Street. Even as

labor markets remain moribund, homeowners continue to face foreclosures, and retailers face bankruptcy, Congress fears voter backlash regarding additional government commitments. While economists make a fine distinction between commitments made by the Fed and those made by the Treasury, voters do not. Uncle Sam is on the hook, no matter who put him there. The public wants to know what good has been accomplished by expanding the Fed's balance sheet liabilities to \$2 trillion dollars and, by extension, Uncle Sam's commitments by perhaps \$20 trillion, through loans, guarantees, and bailouts.

We conclude with a number of important issues surrounding transparency and accountability that we intend to explore in subsequent research:

- Is there an operational difference between commitments made by the Fed and those made by the Treasury? What are the linkages between the balance sheets of the Fed and the Treasury?
- Are there conflicts arising between the Fed's responsibility for normal monetary policy operations and the need to operate a government safety net to deal with severe systemic crises?
- How much transparency and accountability should the Fed's operations be exposed to? Are different levels of transparency and accountability appropriate for different kinds of operations—for example, formulation of interest rate policy, oversight and regulation, resolution of individual institutions, and the rescue of an entire industry during a financial crisis?
- Should safety net operations during a crisis be subject to normal Congressional oversight and budgeting? Should such operations be on or off budget? Should extensions of government guarantees (whether by the Fed or the Treasury) be subject to congressional approval?
- Is there any practical difference between Fed liabilities (banknotes and reserves) and Treasury liabilities (coins and bonds or bills)? If the Fed spends by "keystrokes" (crediting balance sheets, as Chairman Bernanke says), can or does the Treasury spend in the same manner?
- Is there a limit to the Fed's or the Treasury's ability to spend, lend, or guarantee? If so, what are those limits? And what are the consequences of increasing Fed and Treasury liabilities?
- What can we learn from the successful resolution of the 1980s thrift crisis that could be applicable to the current crisis? Going forward, is there a better way to handle the resolution of financial crises, putting in place a template for a government safety net to deal with systemic crises when they occur? (This is a separate question from the creation of a systemic regulator to attempt to prevent crises from occurring; however, Congress should explore the wisdom of separating the safety net's operation from the operations of a systemic regulator.)
- What should be the main focuses of the government's safety net? Possibilities include: rescuing and preserving insolvent financial institutions versus resolving them, encouraging private lending versus direct spending by government to create aggregate demand and jobs, debt relief versus protection of interests of financial institutions, and minimizing budgetary costs to government versus minimizing private or social costs.

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