Churchill, Baruch, Lindsay Lohan, Congress and the Fed

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Winston Churchill was in New York on Oct. 29, 1929, Black Thursday. Bernard Baruch took him to dinner that night with some 40 or so luminaries of finance—"friends and former millionaires," Baruch called them. Churchill listened and, over the course of the evening and the next few days, took measure of the situation. He recorded his impression as follows: No one "could doubt that this financial disaster, huge as it is, cruel as it is to thousands, is only a passing episode in the march of a valiant…people who…are showing all nations much that they should attempt and much that they should avoid." [1]

The historian Martin Gilbert later wrote that in the face of a fearful crisis, Churchill had seen the United States "at its most magnificent and its most tormented." [2]

Move the clock forward 82 years. We have no one on the world stage as eloquent as Churchill. But even the most prosaic observer might now be given to repeating the Last Lion's observation: The financial disaster of 2008 and 2009 was huge. It was cruel not to thousands but to millions of Americans who lost their jobs and saw their savings and standard of living decimated. And yet, painful as it was—and remains for so many—it is proving to be a passing episode in the onward march of a valiant people.

In coping with the crisis and its aftermath, we have seen America at its most magnificent and its most tormented. We have shown others much that they should attempt and much that they should avoid.

You all know what transpired over the past few years, so let me give you an abridged version to set the stage of lessons learned and what I believe we now confront.

During the recent Panic, the most important ingredient in the functioning of financial markets—trust in counterparties—imploded. The liquidity required to finance the business of America disappeared. Interbank lending evaporated. Risk premiums soared. The commercial paper market faltered. A hallmark money market fund "broke the buck." Asset-backed security lending stopped cold. The entire spectrum of financing for businesses collapsed; the gears of the American economy went into reverse. Seemingly overnight, we were transformed from a grand vessel that had been sailing along on the tranquil sea of the Great Moderation into a battered wreck tossed about in a perfect storm threatening to dash us on the rocks of deflation, depression and ruin.

Eager to avoid the mistakes made by our predecessors during the 1930s, and led by an unassuming but determined chairman, the Federal Reserve created a panoply of programs to revive the key financial markets. In the face of widespread fear among businesses and the broader public, consternation among financial operators, and a great deal of breast beating by politicians threatening to compromise the independence that is so vital to operate a successful central bank, the Fed stepped into the breach. It did so in keeping with the ultimate duty of any central bank as lender of last resort: Drawing on emergency powers previously given us by the

Congress, we addressed the exigent circumstances we faced by opening the floodgates to restore the credit markets and pull the economy back from the brink.

The long and short of it all was that the medicine applied by the Federal Reserve worked. Whereas, then there was no liquidity to finance our economy, now there is plenty: Money is cheap; banks and credit markets are flush; the stock market has soared. Financial wherewithal is widely available to businesses, public and private, that have the capacity to put the American people back to work.

To be sure, there are some, including me, who worry that the Fed ultimately may have taken out too much insurance against a double-dip recession and slippage into a deflationary spiral. There are some, including me, who argued against the last tranche of insurance we took out in committing to buy $600 billion in U.S. Treasuries between last November and the end of this coming June as we were simultaneously purchasing additional Treasuries to make up for the roll off in our mortgage-backed securities portfolio. There was a strong feeling among those of my policy persuasion that we had already sufficiently refilled the tanks holding the financial fuel businesses needed to drive their job-creating machines. They felt that by being too accommodative, we might run the risk of planting the seeds that could germinate into renewed volatility, speculation and inflation, or give comfort to a government that for far too many congressional cycles has fallen down on the job by spending and borrowing and committing to unfunded programs with reckless abandon.

But whether you feel that the Federal Reserve has gotten it just right or gone a bit beyond the call of duty, it is hard for anyone to argue that the Fed did not succeed in pulling the financial markets back from the brink and has successfully reliquefied the economy, restoring the flow of the vital lifeblood of commerce.

In an interview published in the *Dallas Morning News* on Aug. 26, 2009, I said the Great Recession was over but that the healing process would take time before gathering momentum and resulting in meaningful job creation.[3] (It took the National Bureau of Economic Research, or NBER, 15 months to reach the same conclusion,[4] leading one of my most prominent colleagues on the FOMC to quip: "And the NBER is expected to soon tell us that Christmas last year occurred on Dec. 25!") We now know the economy bottomed in the second quarter of 2009 and has slowly been gaining momentum since then. As is evident in the latest round of data, a recovery is well under way.

By acting with purpose, I believe the Federal Reserve, in the words of Winston Churchill, did its part to show the world "much that should be attempted and much that they should avoid." We demonstrated that a lender of last resort must avoid being timid in the face of a crisis. We showed our nation, and others who look to us for leadership, that central banks must act deliberately and conduct their duties doggedly, however intense the criticism or political heat. But we also revealed the price of acts of omission—that an institution ultimately responsible for maintaining financial stability can ill afford to be lax in its duties as a regulator and supervisor of systemically critical financial institutions under its jurisdiction—a failure we have taken significant organizational steps to correct and are working hard to avoid letting happen again.

I happen to believe one of the best outcomes of the crisis is that the Fed demonstrated the importance of a central bank keeping its word. We said we would close the numerous emergency programs we engineered once they had done their job. And we have thus far done so. Imagine that: A government agency that (a) does what it says it will do; (b) actually closes down programs once they have served their purpose; and (c) not only does not lose taxpayer money in the process but makes a profit for the Treasury from it.

Yet, though the recovery is gaining strength, we still have a long and arduous path ahead of us. I managed a grin when I read the giddy headline on the release last Thursday of the latest survey of the National Federation of Independent Business: In bold capital letters it proclaimed, "Whoo Hooo. Best Job Creation Number in 3 Years!!" [5] But I suppressed a more fulsome smile. The news *is* better; job creation *is* gathering momentum; the economy *is* moving in the right direction. But it is worrisomely clear that the task of putting millions of unemployed and underemployed Americans back to work will take an anguishing amount of time.

I do not, however, feel that further monetary accommodation will speed the process. It might well retard job creation, should it give rise to inflationary expectations or, worse, imply that, having suffered the slings and arrows of popular and political contempt as we went about doing what we did to save the financial system, we have now been compromised and become a pliant accomplice to Congress' and the executive branch's fiscal misfeasance. I am wary of those risks. Indeed, as a voting member of the FOMC this year, I have made clear within the meeting room and in public speeches that, barring some frightful development, I will vote against any program that might seek to extend or enlarge the substantial monetary accommodation we already have provided, just as I argued against the $600 billion extension the voters on the Committee approved last November. And I remain doubtful enough as to its efficacy that if at any time between now and June, it should prove demonstrably counterproductive, I will vote to curtail or perhaps discontinue it. As I said, the liquidity tanks are full, if not brimming over. The Fed has done its job. What is needed now is for business to be incentivized to commit that liquidity to creating American jobs. This is the task of the fiscal authorities, not the Federal Reserve.

Here, I see the America that Churchill described as being "at its most magnificent and its most tormented."

The backbone of our economy, private business, is magnificently lean and fit. American business operators began to trim down and shape up their operating efficiency during the inflationary scare that threatened their profits running up to the summer of 2008. When the wheels came off the bus that fall and demand collapsed, they drove themselves to still greater efficiency to preserve their bottom lines or just to survive. The most expensive cost for most all businesses is labor. Over the past cycle, American businesses have learned to use the least amount of workers to drive the most amount of productivity. Today, our economy produces as much output as it did in 2007 before the onset of the crisis. But it uses over 7 million fewer workers to do so. From an economic standpoint, this efficiency is, indeed, a magnificent thing. And yet widespread unemployment is tormenting our society. The vexing question is: How will millions of Americans be put back to work in timely fashion?

All business operators, public or private, large or small, have a duty to their shareholders or their creditors to earn the highest return on investment possible. In a globalized economy, they can go anywhere on earth to do so. They can invest in China. Or India. Or Vietnam or Singapore or Brazil or Mexico or Africa. Or anywhere in an expanded, post-Cold War Europe. Nothing short of the poison of capital controls or protectionism can prevent them from doing so. Which raises the question: What must now be done to get businesses to invest in job creation here at home with the cheap and abundant money the Fed has made possible?

The obvious answer is that they must have confidence in the future of America. Businesses, like any other economic actor, will respond to immediate tax and regulatory incentives. But to make long-term investment decisions that create permanent, remunerative jobs they must have confidence in the long-term prospects of where they invest. In my judgment, it will be hard to secure that needed comfort until Congress makes clear it will refrain from the errant fiscal ways of the past, changes the way it taxes and spends and regulates, and places the nation demonstrably, and unalterably, on a path of fiscal rectitude.

I was quoted in the *Washington Post* on Feb. 21 as saying that we had suffered for too long from "Lindsay Lohan" Congresses.[6] Like Ms. Lohan, the American Congress is a beautiful creation, blessed with enormous talent. But it has been waylaid by addiction—in the case of the Congress to spending and debt—and by a proclivity for shoplifting—in the case of the Congress to pocketing for their immediate gratification the economic future of our children and grandchildren and our grandchildren's children.

Reasonable arguments can be made that fiscal policy must loosen during cyclical downturns to provide an economic environment conducive to growth. Some economic research even points to deficit spending as an essential ingredient for recovery when interest rates are near the so-called zero bound or the Fed has reached the limit of prudent monetary accommodation through other means. We certainly have put that theory to the test during the past two fiscal years, running deficits of $1.3 trillion in 2010 and an expected $1.65 trillion in 2011.

What's troubling about the fiscal situation, however, is the likelihood of persistent large yearly deficits long after the current recession is behind us. The same economic theory that prescribes deficits during recession prescribes surpluses during recovery to help meet the next economic challenge that might develop. If current deficits were exclusively due to cyclical phenomena, one would expect to see surpluses as we distance ourselves from the Great Recession we have just experienced. Instead, as far as the eyes of the analysts at the Office of Management and Budget can see, deficits will remain slightly above the 3 percent GDP threshold at which it is feared significant crowding-out of private sector economic activity begins to appear.[7] And other observers, under less optimistic assumptions, foresee significantly higher deficits in the years ahead.

The U.S. economy is afflicted with the pathology of structural deficits. This leaves the nation poorly positioned to weather the next recession or shock to come our way. I devoutly hope our next downturn won't come for quite some time, but it surely will come eventually. Will we follow the lead of the biblical Joseph, storing fiscal grain during boom times in preparation for the lean times that will, inevitably, someday follow? Or will we take the opposite course and run larger-than-normal deficits every year, hindering our ability to respond when the current expansion ends or an unforeseen crisis occurs, thereby undermining the confidence needed by businesses to commit sustainable job-creating capital here at home?

It is important to note that institutionalized deficits are cruelest to future generations. What has made the United States an exceptional economic haven for investment and growth has been the certain knowledge that the successor generation would enjoy a better standard of living than the current one—that ever-expanding prosperity was built into the system. Encumbering future generations with debt dashes that promise. Instead of passing the torch of prosperity to the successor generation, the fiscal authorities have been passing them the bills. If our Congress continues to provide more in services than they are willing to collect in taxes, it is a mathematical certainty that the well-being of our progeny will suffer. Correcting this pernicious dynamic is imperative for assuring our economic future.

It is not the job of the Federal Reserve to conduct fiscal policy. It is not for me or any other Federal Reserve official to advise Congress on particular tax or expenditure choices. Yet the overall stance of fiscal policy is very much relevant to monetary policymakers. A large and growing government debt inevitably places pressure on the Federal Reserve to hold interest rates too low for too long, making it more difficult for the Fed to fulfill its dual mandate of price stability and full employment.

Throughout history, feckless governments have dodged their fiscal responsibility by turning to their monetary authority to devalue the currency, monetize debt and inflate their way out of structural deficits If we are to live up to Churchill's charge to show the world what must be avoided, the world's foremost central bank—keeper of the premier reserve currency and bulwark against its debasement—cannot, and must not, ever succumb to such pressure. It is thus best for everyone—future generations and the current one alike—that our fiscal leaders not go there. For such an action would precipitate a showdown that would be anything but "magnificent" to behold. Congress and the executive branch thus have no choice but to now suck it up, make some painful choices and get on with the business of putting our valiant nation on a more sustainable fiscal course. I, for one, am pleased to see that a dialogue toward this end has begun. Let us hope it results in meaningful action.

Thank you.

Notes

[1] *Best Little Stories From the Life and Times of Winston Churchill*, by C. Brian Kelly and Ingrid Smyer-Kelly, Nashville: Cumberland House Publishing, 2008, p. 169.
[2] See note 1. Also see *Churchill and America*, by Martin Gilbert, New York: Free Press, 2005.
[3] "Recession Over, Dallas Fed Chief Says, But Jobs Lag," by Brendan Case, *Dallas Morning News*, Aug. 26, 2009.
[4] See www.nber.org/cycles/sept2010.html.
[5] A full report covering the National Federation of Independent Business' latest survey of small business development will be released on March 8.
[6] "Dallas Fed President: 'We're Moving Forward,'" by Neil Irwin, *Washington Post*, Feb. 21, 2011.
[7] These figures come from the president's 2012 budget, available online at www.whitehouse.gov/omb/budget/Overview/.