'Is America's Decline Exaggerated or Inevitable?' The Role of Monetary and Fiscal Policy

(With Reference to St. Peter, Calvin Coolidge, Walter Bagehot, Paul Volcker, Winston Churchill and T.R. Fehrenbach)

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In the fall of 2006, I was asked to draw upon some 30 years of experience in Germany and speak at the American Academy in Berlin, addressing the question: "Is Germany's Decline Exaggerated or Inevitable?"[1] This was against the backdrop of reforms that had been initiated by the former German Chancellor Gerhard Schroeder, and carried on by his successor, Angela Merkel. I argued that Germany's economic fate and position as *primus inter pares* in Europe was at a tipping point. The answer to the question of whether Germany was fated for decline or ascent depended upon how Germans would adapt their education system, labor laws, health care system, financial infrastructure, corporate governance, tax regime and myriad other changes needed to advance their economic competitiveness in a world being transformed by the forces of globalization and cyber-ization. I ended that speech by saying I was encouraged that changes had been initiated, but drew on St. Peter and Calvin Coolidge, neither of whom would have considered themselves economists, to underline the essential ingredient for success in these critical initiatives. For it was St. Peter who urged, "Be serious and discipline yourselves."[2] And it was Silent Cal who said, "Nothing in this world can take the place of persistence. …The slogan 'press on' has solved and always will solve the problems of the human race."

Two weeks ago, I was back in Germany. My interlocutors there, having been serious, determined and persistent in implementing change and who are now sitting rather pretty, turned the question back on me, asking: "Is America's Decline Exaggerated or Inevitable?" I thought I would speak to that question today.

For those of you who are impatient, the answer is: "It depends." It depends not upon the outcome of the conflicts in North Africa and the Middle East, nor upon the effect of the tsunami and the disruption of nuclear facilities in Japan, nor upon any of the other pressing issues of the moment that are the subject of day-to-day angst assiduously reported by your colleagues in the press.

It depends upon monetary and fiscal policy.

It depends upon whether the United States can get its economic house in order.

It depends, in the end, upon whether the Federal Reserve, as the nation's central bank, and the Congress, working with the executive branch in discharging its duty as the nation's fiscal authority, will adhere to the maxims of St. Peter and President Coolidge—whether each of these institutions has the will to be serious and discipline itself, and be persistent in pressing on with their respective duties.

Monetary Policy

I'll start with the Federal Reserve.

In contemplating future policy of the Federal Reserve, it is important to remember the frightful predicament we faced in the fall of 2008. The financial gears of our economy—the most powerful and important economy in the world—had ground to a halt. The entire panoply of markets for financial instruments essential to the daily lives of businesses and individual citizens—interbank lending, commercial paper, asset-backed lending, money-market mutual funds and the mortgage markets—seized up. In the blink of an eye, liquidity and trust in financial counterparties disappeared. In those darkest of days, a colleague of mine wittily summed up what had transpired by noting that on the balance sheets of the most important financial institutions, "nothing on the right is right and nothing on the left is left."

We could have an endless discussion of who was responsible for this so-called black swan scenario. We would likely agree that it resulted from a combination of factors, including the speculative excesses that occur when interest rates remain too low for too long; the consequences of systemically important bank and financial intermediaries embracing risk-management tools that are formulaic and dependent upon "quant jocks" rather than upon common sense and good judgment; the abuses that ensue when regulatory authorities let down their guard; the comeuppance that inevitably occurs when policymakers and their advisers are lulled into complacency with theoretically comforting, but nonsensical, shibboleths like "efficient markets"; or just the financial tomfoolery that disturbingly repeats itself at periodic intervals throughout history when, in the memorable words written in 1856 by the English essayist Walter Bagehot, "[A]t particular times … people have a great deal of … money…. At intervals … the money of these people … is particularly large and craving: it seeks for some one to devour it, and there is [a] 'plethora'; it finds some one, and there is 'speculation'; it is devoured, and there is 'panic.'"[3]

Regardless of how it came to be, when the Panic of 2008 occurred, the Fed did what central banks are called to do when pandemonium strikes: As the lender of last resort, we stepped into the breach, used the powers given to us by our government to create money and credit, and deployed the considerable array of tools at our disposal to calm and restore the financial markets.[4]

The Bernanke-led Federal Open Market Committee (FOMC) had confidence in the programs we undertook, for they were well-vetted, disciplined and carefully considered. We persisted with them even though our actions gave rise to great consternation and warnings of bleak consequences from an understandably anxious Congress, skeptical financial pundits and frightened citizens. Teddy Roosevelt once said, "When people lose money, they strike out unthinkingly, like a wounded snake, at whoever is most prominent in the line of vision."[5] The Fed—as the nation's central bank and first responder to a financial crisis—was front and center in dealing with the panic, and we felt the sting of a rattled public and its elected representatives. Still, we "pressed on."

We now know that the exigent measures we undertook worked. The end result of the Fed's efforts was that the credit markets and the lifeblood of liquidity needed to conduct commerce and sustain the economy were restored. The economy responded and began a recovery in the middle of 2009 that is slowly gaining steam and now appears to be self-sustaining.

Imagine that! A government agency that (a) devised programs that actually worked, (b) shut most of them down when they had done their job and (c) made money for the taxpayer in the process.

This is not to say there was no cost to what we accomplished. There were trade-offs and unintended consequences, some of which were distinctly unpleasant.

In saving the system, for example, it can be argued that we protected imprudent lenders and investors from the consequences of their decisions; we rescued sinners and penalized the virtuous.

Postcrisis, the "too big to fail" financial behemoths that had placed our economy in jeopardy have ended up with even greater financial power. (And, adding insult to injury, by the grace of their shareholders, most of their leaders retain their posts and few, if any, have suffered financial setbacks). This concentration of power comes at the expense of community and regional banks, an imbalance that the Federal Reserve and other authorities must now address through tough-minded, clear-eyed regulation.

At the individual citizen's level, we eased the pain of overextended homeowners with mortgages by buying up \$1.25 trillion in mortgage-backed securities and driving mortgage rates to historic lows. The Fed's interventions to drive interest rates to historically low levels resulted in significant capital gains for bondholders and equity investors in the most plain-vanilla securities and mutual funds. Yet, by taking interest rates to zero and making money cheap and abundant so as to reliquefy the economy, those who invested the most conservatively—tucking their savings away in the safest of vehicles, like CDs, money market funds, and Treasury bills and notes—saw the income earned on their hard-earned savings dramatically reduced.

I personally fret over these and other costs, but on net, I believe the Federal Reserve did what is expected of a responsible central bank: We stemmed a panic and averted a depression.

While we have wound down most all of our exigent programs, we remain with a bloated balance sheet, with footings in excess of \$2.4 trillion, roughly triple the size of our precrisis balance sheet. And the composition of our balance sheet has changed: We hold about \$937 billion in mortgage-backed securities and over \$1.3 trillion in Treasury securities, including those of longer duration than is typical.

When we buy an interest-bearing security from the market, we pay the seller of that security. This expands liquidity in the system. Whereas in the Panic there was no liquidity, today our large-scale asset purchases have made for abundant liquidity. Banks have \$1.4 trillion in excess reserves parked in the 12 Federal Reserve Banks; other financial intermediaries are flush with cash; there is a surfeit of cash on the books of corporations and nonfinancial businesses, and more is available at little cost through a robust bond market and a fully recovered stock market.

Personally, I felt the liquidity needed to propel our economy forward was sufficient even before the FOMC opted last November to buy \$600 billion in additional Treasuries on top of the committee's pledge to replace the runoff of our \$1.25 trillion mortgage-backed securities portfolio. I argued as much at the FOMC table. I considered the risk of deflation and of a double-dip recession to have receded into the rearview mirror. In fact, I gave an interview to my introducer here, Mr. [Brendan] Case, that was published under his byline in the *Dallas Morning News* on Aug. 26, 2009, in which I said the recession was over and the long slog of recovery from the Great Recession had begun.[6] Last November, I felt the problem was not the lack of liquidity in the economy, but that regulatory and fiscal uncertainty—the handiwork of fiscal authorities and lawmakers, not the Fed—was inhibiting the deployment of that liquidity into job creation. I also worried that these simultaneous programs would have the effect of buying up—of "monetizing"—the equivalent of most all of the U.S. government's issuance of new debt through June of this year, a dangerous course for any central bank to embark upon.

The majority of my colleagues on the FOMC felt differently, and the committee voted to initiate the program now known as QE2. Whether you feel that we are providing a prudent amount of liquidity, as they do, or too much, as I do, I think you would be hard-pressed to dispute that there is now plenty of fuel in the tanks of American businesses to finance expansion and put unemployed and underemployed Americans back to work.

Having done our job, I see many risks to the Fed overstaying its welcome.

There are perceptional risks, for example. Our duty is most distinctly not to monetize—or even be perceived as monetizing—the debt of fiscally imprudent government. Throughout the history of nations, monetizing the budgetary excesses of governments has proven to be a direct path to economic perdition. Having already peeked inside that door, I feel strongly that we must now shut it, lock it and throw away the key.

There is the risk that we might breach our duty to hold inflation at bay. Inflationary impulses are gaining ground in the rest of the world. At the core of the euro zone, Germany, where unemployment is actually lower than before the crisis, wage inflation is pressing up against 3 percent. Retail price inflation in the United Kingdom now exceeds 5 percent, despite very high unemployment. Reported inflation now exceeds 4.5 percent in China, 6 percent in Brazil and 8 percent in India.

We know from anecdotal soundings that American businesses, like businesses in other countries, are doing their utmost to offset with higher prices the surging costs of inputs such as fuel, other commodities and materials, and components, parts and processes sourced from abroad. My gut tells me that this will result in some unpleasant general price inflation numbers in the next few reporting periods, even though the trimmed-mean inflation rate we calculate at the Federal Reserve Bank of Dallas—based on the price movements of 178 personal consumption expenditure items—while rising, has over the past six months run at a sedate rate of 1.2 percent.

Given that we still have significant excess capacity of unemployed workers, extremely subdued wage growth, strong productivity growth and weak domestic demand, one might reasonably posit that the general inflationary pressures we are experiencing presently are transitory. Nonetheless, adding still more liquidity, or not withdrawing in a timely manner what we already provided in abundance, would do nothing to quell emerging inflationary pressures and might well compound them, proving doubly injurious to savers and the earnings of those who do have jobs.

And there is always the risk that, having provided so much liquidity, we might unwittingly abet a resurrection of the tomfoolery so well-described by Bagehot. Some disturbing practices are beginning to rear their ugly heads again: We have seen a resurgence of "covenant-lite" loans, with some $24 billion issued in the first quarter versus $100 billion for all of 2007; private-equity firms are back in size and turning to leverage to pay dividends; credit-boom acronyms most thought would never return after the Panic, such as "payment-in-kind," or PIK, and "toggle" notes, are prominent once again; traditionally unleveraged asset managers, such as insurance companies and pension funds, are turning to leverage and exotic asset classes to juice returns. These are all signs of the intoxicating effects of the ambrosia of inexpensive and plentiful money. Further spiking the punch bowl with accommodative monetary policy would do nothing to rein them in.

In summarizing the monetary side of the equation, I would argue that the Federal Open Market Committee did its job. In the face of great skepticism and cynicism, we persisted and pressed on with doing what central banks are supposed to do to pull an economy back from the brink. We reliquefied the financial markets: Liquidity is no longer scarce. Money is no longer dear; it is cheap. Job-creating businesses have the financial means to get on with putting Americans back to work. Continued accommodation presents significant risks. In my view, no amount of further accommodation by the Fed would be wise—either by prolonging or "tapering off" the volume of purchases of Treasuries past June, or adding another tranche of large-scale asset purchases. Indeed, it may well be that we should consider curtailing what remains of QE2.

Now, we at the Fed are nearing a tipping point. Just as we pressed on in doing our duty through extraordinary, exigent measures, we must now discipline ourselves to just as persistently normalize our operations in a timely way.

Fiscal Policy

As for the fiscal side of the equation, you know the story. I have been harping on this for years. I spoke of the dangers of what in polite parlance might be called the fiscal incontinence of Congress when I addressed the Commonwealth Club of California in May of 2008.[7] Under both Republican and Democratic leadership, past Congresses have created a fiscal sinkhole that is so deep and so wide, it threatens to swallow up our prosperity and render our economy an abattoir. They have forsaken the most sacred responsibility they have to successor generations of Americans: Instead of passing the torch to our children, they have passed them the bill.

Past Congresses have made promises they cannot keep. Now, the new Congress is embarking on a corrective course. This is just the beginning of what I expect to be a long, arduous exercise. Here I evoke St. Peter: Congress, "be serious and discipline yourselves." You have no choice but to go through a painful and gut-wrenching rehabilitation and begin leading a sober life of living within your means. You must press on with getting your accounts in order, however politically unpleasant it may be to do so.

This will be a titanic struggle. Our Congress must find a way to align spending with income through taxation that (a) does not cut off the incipient economic recovery, (b) provides a credible path toward bringing their accounts—including the unfunded liabilities of Medicare and Social Security—to solvency and (c) respects the fact that in a globalized, cyber-ized world, those with the ability to create jobs may create them in places that offer more compelling fiscal and regulatory environments.

This last point is not unimportant. Permanent jobs are created by the private sector. Businesses, large and small, publicly or privately held, have a duty to earn a return on investment for their shareholders. In a globalized, cyber-ized world, they need not invest or expand their payrolls in the United States; they are free to go practically anywhere on the planet. This is the result of one of our greatest accomplishments as a nation: We won the Cold War. Before the demise of the Soviet Union and the death of Mao, we lived in a world of mutually assured destruction; today, we live in a world of mutually assured competition. This is what we spent an entire generation of blood and national treasure to achieve. Now, those with the power to levy taxes and direct spending must get with it and adjust to the new world as they seek to incentivize job creation through businesses that, thanks to monetary policy, now have the financial means to put Americans back to work right here at home.

There cannot be robust direct investment in the United States without confidence in the nation's ability to reverse its budgetary death spiral, especially the inexorable accumulation of national debt and unfunded liabilities of Medicare and Social Security. The need to break the back of that spiral is as dire now as was the need for Paul Volcker to break the back of inflation in the 1980s. Those who are leading the charge to restore fiscal sanity, be they Republican or Democrat, will no doubt recall the personal vitriol hurled at the then-Fed chairman; they should steel themselves against it. They should remember that, as a result of his steadfast determination to press on with exorcising inflation, Mr. Volcker is today among the most respected living Americans and widely considered an exemplar for public servants worldwide.

Getting our fiscal house in order will not be an easy task. But there are worse alternatives. Resorting to protectionism or capital controls or sustained negative real interest rates or inflation, in lieu of real fiscal reform, would be pyrrhic solutions.[8] Corrupting the independence of the Fed would surely lead the nation to the same fate that befell Weimar Germany and Peron's Argentina when their central banks took to monetizing debt. The nation cannot, must not, and, in my view, will not go down those sordid paths. Indeed, I sense we have turned the corner and are on the road to fiscal redemption, however bumpy it might be.

My German interlocutors asked why I am encouraged that we would now finally get on with the business of cleaning up our fiscal house. Central bankers are, after all, genetically programmed to be sourpusses; we are inherently wary of the capacity of politicians to be serious and discipline themselves.

My answer is admittedly emotional. I am the son of immigrants; my parents came to this country because it is the land of promise. Moreover, I am a naturalized Texan, and Texans are a persistent people who have always pressed on against the odds. The great historian of Texas, T.R. Fehrenbach, wrote that Texans understand that "men who exist get overrun by men who act."[9] I believe deep in my heart that this is not unique to Texans—it is a quintessential American trait. I believe that the people of this great country will reward those members of Congress who act and will overrun those who exist only to encumber us with unsustainable debt and an imbalance of taxes and spending that threatens our prosperity rather than advances it. So, yes, I am hopeful that our elected leaders will get on the stick.

Besides, I believe Winston Churchill had it right: "Americans can always be counted on to do the right thing … after they have exhausted all other possibilities."

Thank you. In the best tradition of central bankers, I would be happy to avoid answering your questions.

Notes

[1] "Is German Economic Decline Exaggerated or Inevitable?" speech by Richard W. Fisher, Nov. 20, 2006, www.dallasfed.org/news/speeches/fisher/2006/fs061120.cfm.
[2] From 1 Peter 4:7, New Revised Standard Bible.
[3] See "Edward Gibbon," *National Review*, January 1856, 1–32.
[4] Title XI of the Dodd–Frank Wall Street Reform and Consumer Protection Act has since amended the Federal Reserve Act to restrict 13(3) emergency lending to programs with prior approval of the Secretary of the Treasury and designed to provide liquidity to the financial system, not an individual entity or insolvent firm(s).
[5] See *Churchill*, by Paul Johnson, New York: Penguin Group, 2009, pp. 52–4.
[6] "Recession Over, Dallas Fed Chief Says, but Jobs Lag," by Brendan Case, *Dallas Morning News*, Aug. 26, 2009.
[7] "Storms on the Horizon," speech by Richard W. Fisher, May 28, 2008, www.dallasfed.org/news/speeches/fisher/2008/fs080528.cfm.
[8] See "The Liquidation of Government Debt," by Carmen M. Reinhart and M. Belen Sbrancia, NBER Working Paper no. 16893, National Bureau of Economic Research, March 2011.
[9] *Lone Star: A History of Texas and the Texans*, by T.R. Fehrenbach, New York: Macmillan Publishing Co., 1985, p. 717.