MONETARY POLICY AND THE DEBT CEILING: EXAMINING THE RELATIONSHIP BETWEEN THE FEDERAL RESERVE AND GOVERNMENT DEBT

HEARING

BEFORE THE

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AND TECHNOLOGY

OF THE

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Wednesday, May 11, 2011

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC MONETARY
POLICY AND TECHNOLOGY,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Ron Paul [chairman of the subcommittee] presiding.

Members present: Representatives Paul, McHenry, Luetkemeyer, Huizenga, Schweikert; Clay, Maloney, and Peters.

Ex officio present: Representative Frank.

Chairman PAUL. This hearing will come to order. Without objection, all members' opening statements will be made a part of the record.

I would like to go ahead and start with our opening statements and then get to our introductions.

Today's hearing deals with monetary policy and the debt ceiling and examining the relationship between the Federal Reserve and government debt. The government debt, the national debt now is a big issue mainly because the debt limit has once again been met, and the Congress has to go through the process of raising the debt limit.

The question is whether or not monetary policy is in any way related to the debt increase. Some say it is related; some say it is not. And the statistics are available to us to study that issue.

But to me, it looks like there is a relationship. It seems like the Federal Reserve System provides a moral hazard, and that as long as Congress knows that Treasury bills will be bought and interest rates will not be allowed to rise, therefore the Congress is more careless.

If we had no monetization of debt, which would annoy a lot of people, I am sure, who think the world would come to an end if that happened, the Congress would be self-regulated in many ways, because if we in the Congress spent excessively and we taxed excessively and borrowed excessively and we still didn't have enough money to keep interest rates reasonably low, interest rates would rise.

And it would be Congress that would have to respond and not be bidding for so much capital out of the market, and therefore wouldn't be tempted to say, "Well, it really doesn't matter. We have an emergency. We have a war going on. We must finance the war. We have an entitlement system that depends on this, so therefore if we print the money, this will take care of things."

It may well take care of things for a while, but ultimately, this process will run up against a stone wall. And I think that is where we are today.

We have raised the debt limit many times over the years, and it has been generally a non-event. It used to be that when you passed a budget resolution, the only part that was actual law was raising the debt limit. It wasn't even debated. It was just generally done.

But things have been moving along rather rapidly, and I cannot believe that what we are doing is sustainable. Right now, we are accumulating obligations. When you look at the deficit plus what we borrow from our trust funds plus our increase in our entitlement obligations, there are good estimates made that this amounts to about $5 trillion a year. And that, obviously, is unsustainable when we have a weak economy, jobs are going overseas, we are not producing, and we are in the midst of a slump.

The solution hardly seems to be just more debt and depending on the Federal Reserve to come to our rescue while devaluing the currency, which means that many people that some of this deficit financing is supposed to help will actually be hurt by it, because they are the ones who lose their jobs, and then they end up with the prices going up because of the debasement of the currency. So this deficit financing seems like it can't last forever.

When the Fed was started, we didn't have the same type of monetary statistics that we have today. But the base at that time, the monetary base at that time, was probably around $4 billion. By 1971, at the time when we lost the last leak of our dollar to gold, it was about $67 billion. But with the removal of any restraint on the Fed to buy debt, the monetary base went up to $616 billion.

Now, in this last decade, which has been a decade of economic weakness, real income has not gone up. Good jobs have not been added; they have been leaving our country because of our economic problems. But in these last 10 years, the monetary base has jumped from 616 billion to $2.5 trillion, so there is a lot of activity going on there.

I also find that if you look at the debt during this period of time, of course, in 1913 the debt was practically irrelevant, a couple of billion dollars, but by 1971, incrementally, on a weak economy, the debt went up to $398 billion. Ten years ago, it was $5.8 trillion, but in this weakened economy, it has jumped up to $14 trillion.

And I think what is interesting is that if you still pay a little bit of attention to M3, which we are not allowed to see any more from the Fed, because it costs too much money to produce those statistics, M3 is $14 trillion, and the national debt is $14 trillion. I don't know how coincidental that is, but I just think there is a relationship to that.

We have the statistics from the Fed that tell us about how many Treasury bills they are buying, and they are buying routinely. But what we don't know is whether or not—because we don't have a full audit of the Fed—we extend loans to other foreign banks with the quid pro quo for them to buy Treasury bills, because foreigners are still buying a lot of our debt.

But, it is interesting to see how passionate this whole argument about raising the debt limit is. It was a former Secretary of the Treasury who just recently said that if we don't bow down, immediately raise this level, it will be so destructive that it would actually be equivalent to a terrorist act. That is how serious it is.

The whole thing is they said, "Well, we can't default." But we started our country by defaulting. I don't endorse this idea, but we started it. We defaulted on the continental dollar. We defaulted in the Civil War period. We refused to pay what we promised to pay in gold. They just unleashed unlimited spending.

We defaulted in the 1930s, took the gold from the people, and didn't pay off the gold to the people. We took it from them. And then in 1971, we defaulted again. We said to foreigners, "No." We said we would honor our dollar at $35 an ounce, and we just quit.

So we have defaulted many times. Sure, there are going to be problems if we don't raise our national debt, but I think if we don't cut the spending, that kind of a default is going to be much, much worse.

And now I yield to Mr. Clay, the ranking member.

Mr. CLAY. Thank you, Chairman Paul. And thank you for holding this hearing regarding the Federal Reserve's role in United States monetary policy and the responsibility to address the U.S. budget deficits.

To address this issue of the Federal Reserve's role in the economy, we have to address the Federal Reserve's dual mandate it has to maintain stable prices and full employment. And we also have to have an adult conversation here in Washington about this credit card mentality we have of putting big-ticket items on a national credit card.

I think that has to stop, when you think about the last decade, how we conducted two wars without having a way to finance those wars. We had a prescription drug benefit instituted without a way to pay for that.

Those are just two examples of what is wrong with the Washington mentality, so I agree with you. We have to have an adult conversation. Hopefully, this hearing can be the start of it.

Mr. Chairman, I yield back.

Chairman PAUL. I thank the gentleman.

I now yield 5 minutes to Congressman Huizenga.

Mr. HUIZENGA. Thank you, Mr. Chairman. I appreciate the opportunity and I appreciate our panel of witnesses coming and speaking to us today. And I, too, Mr. Chairman, appreciate your willingness to hold this hearing and leading this conversation in so many ways.

My constituents—I am from Michigan, the west side of Michigan, so I am very familiar with our friends over on the other side of the State at Northwood, but my constituents in the 2nd District have made it very, very clear that the debt and our spending is one of the most vital issues that is facing not just this current Congress, the 112th Congress, but us as a nation and to us as a people and our way of life.

And they are asking us to rein our spending in, reduce our massive debt. And that is why I think it is so important that we are holding this hearing.

The Federal Reserve Board of Governors is congressionally mandated, as we all know, to maximize employment as well as to hold down inflation. But after witnessing this massive debt load that has been accumulated by other Administrations, but has ramped up in this current Administration, it seems to me that those are really failed fiscal policies.

And I am pleased that we are now spending some time exploring the role of monetary policy and the national debt. I am very concerned about the liquidity that has been put into markets by the Fed. And through the purchase of those debts and most recently through the fact that Federal funds rates sit at basically zero, we have had to go through, or haven't had to go through—the Fed made the decision to go through by purchasing an additional $600 billion in Treasury securities with utilizing the philosophy of quantitative easing.

And we have gone through QE1 and now QE2, and despite purchasing $1.2 trillion previously in March of 2009, it seems to me it has not proved to be an effective method of creating jobs. And I would love to have your input on that.

Today, we will examine what effect the Fed's government debt plays on the Federal Reserve's open market operations. In addition, I look forward to inspecting how that role affects our yearly deficits when compared to the more costly tax-and-spend fiscal policies that we have had.

And I take my charge here as a Member, as a freshman Member of this 112th Congress and as a member of this important subcommittee, I take my responsibility for strict oversight of taxpayer dollars with the utmost seriousness. And I know that has to be done.

We have been irresponsible in the past, I believe, with the trust that we have been given by the American people. And it is time that we step up and take care of that.

I look forward to a robust conversation today. I am sure that there are a number of differing opinions here. And as we are exploring sort of the Fed's unparalleled intervention in the markets, I am looking forward to hearing from you.

So again, Dr. Paul, Chairman Paul, I appreciate the opportunity to be a part of this committee and a part of this hearing and I look forward to that. Thank you.

Chairman PAUL. I thank the gentleman.

Does anybody else care to make an opening statement?

Thank you.

Without objection, the written statements of our witnesses will be made a part of the record, and each of you will be granted 5 minutes to summarize what you have to say, and then we will go into the questions. I will go ahead and introduce the panel now.

The first panelist is Dr. Richard Ebeling, a professor of economics at Northwood University in Midland, Michigan. He is recognized as one of the leading members of the Austrian School of Economics.

He is a former president of the Foundation of Economic Education and author of, "Political Economy, Public Policy and Monetary Economics." Dr. Ebeling earned his Ph.D. in economics from Middlesex University in London.

Also with us today is Mr. Bert Ely. He is the principal of Ely & Company. He has consulted on banking issues since 1981 and has focused in recent years on banking problems, housing finance, and the crisis in the entire U.S. financial system.

Mr. Ely frequently testifies before Congress on banking issues and continuously monitors conditions in the banking industry, as well as monetary policy. Mr. Ely received his MBA from Harvard business school.

Also with us today is Dr. Matthew Slaughter. He is associate dean of the MBA program at the Tuck School of Business at Dartmouth. He is also a research associate at the National Bureau of Economic Research and a member of the State Department's Advisory Committee on International Economic Policy.

During the George W. Bush Administration, he served as a member of the President's Council of Economic Advisors. Dr. Slaughter is co-author of, "The Squam Lake Report: Fixing the Financial System." Dr. Slaughter received his doctorate from MIT.

And we will go ahead and recognize Dr. Ebeling at this time.

STATEMENT OF RICHARD M. EBELING, PROFESSOR OF ECONOMICS, NORTHWOOD UNIVERSITY

Mr. EBELING. Mr. Chairman, I would like to thank you and the other committee members for this opportunity to testify on our current fiscal crisis and the issue of raising the government's debt ceiling.

The current economic crisis through which the United States is passing has given heightened awareness of the country's national debt problem. Between 2001 and 2008, the national debt doubled from $5.7 trillion to $10.7 trillion and has grown by another $3.6 trillion in the last 3 years to a total of $14.3 trillion.

As I point out in my written testimony, this addition to the national debt since 2008 represents a huge sum. It is 2 times as large as all private sector manufacturing expenditures and nearly 5 times the amount spent on non-durable goods in 2009. The interest payments alone during the first 6 months of the current fiscal year are equal to 40 percent of all private-sector construction spending in 2009.

This highlights the social cost of government spending above what it already collects in taxes from the American public. Every dollar borrowed by the United States Government and the real resources that dollar represents in the marketplace is one dollar less that could have been available for private sector investment, capital formation, consumer spending, and other uses that could have been put to work to improve the quality and the standard of living of the American people.

The bottom line is that over the decades, the government, under both Republicans and Democrats, has promised the American people, through a wide range of redistributive and transfer programs and other ongoing budgetary commitments, more than the U.S.

economy can successfully deliver without seriously damaging the country's capacity to produce and grow for the rest of the century.

To try to continue to borrow our way out of this dilemma will be just more of the same on the road to ruin. The real resources to pay for all the governmental largesse that has been promised would have to come out of either significantly higher taxes or crowding out more private sector access to investment funds to cover continuing budget deficits.

Whether from domestic or foreign lenders, the cost of borrowing will eventually and inescapably rise. There is only so much savings in the world to finance both private investment and government borrowing, particularly in a world in which developing countries are intensely trying to catch up with the industrialized nations.

Interest rates on government borrowing will rise, both because of the scarcity of savings to go around and lenders' concerns about America's ability to tax enough in the future to pay back what has been borrowed. Default risk premiums need not only apply to countries like Greece.

Reliance on the Federal Reserve to print our way out of this dilemma through more monetary expansion is not and cannot be the answer. Printing paper money or creating it on computer screens at the Federal Reserve does not produce real resources.

It does not increase the supply of labor or capital, the machines, tools and equipment out of which desired goods and services can be manufactured or provided. That only comes from work, savings, and investment, not from more green pieces of paper with Presidents' faces on them.

As I point out in my written testimony, monetizing the debt refers to the creation of new money to finance all or a portion of the government's borrowing. Since 2007–2008, the Federal Reserve, through either buying U.S. Treasuries or mortgage-backed securities, has in fact increased through the money multiplier of fractional reserve an amount already equal to about two-thirds of all of the government's new deficit spending over the last 3 years or so.

The fact is the Federal Reserve has more or less monetized—that is, created paper money—to cover a good portion of what the government has borrowed. The bottom line is that government is too big. It spends too much, taxes too heavily, and borrows too much.

For a long time, the country has been treading more and more in the direction of increasing political paternalism. The size and scope of the Federal Government has to and must be reduced dramatically to a scale that is more consistent with the limited government vision of our founding fathers, as is outlined in the Declaration of Independence and formalized in the Constitution of the United States.

The reform agenda for deficit and debt reduction, therefore, must start with the promise of cutting government spending and having a target downsizing of the government. As I suggested in my remarks, the Federal budget should be cut 10 to 15 percent each year across-the-board to get government down to a more manageable, traditional constitutional size.

As a first step in this fiscal reform, it is necessary to not increase the national debt limit. The government should begin now living within its means—that is, the taxes currently collected by the Treasury.

In spite of much of the rhetoric in the media, the United States need not run the risk of defaulting or losing its international financial credit rating. Any and all interest payments and maturing debt can be paid out of tax receipts. What will have to be reduced are other expenditures of the government.

The required reductions and cuts in various programs should be viewed as a necessary wake-up call for everyone in America that we have been living beyond our means. And as we begin living within our means, priorities will have to be made and trade-offs will have to be accepted as part of the transition to a smaller and more constitutionally limited government.

In addition, we have to rein in the power of the Federal Reserve. As I point out in my comments again, the power of discretionary monetary policy must be removed from the hands of the Fed.

They have too much authority to manipulate the supply of money in the economy, to influence the purchasing power of the monetary unit, and to distort interest rates, which influences the savings and investments in the economy that easily set in motion the boom and bust of the business cycle.

It is necessary first to think of seriously returning to a monetary system as a transition that is a commodity-backed system, such as a gold standard. And we should in the long run seriously consider the possibility of even a monetary system completely privatized and competitive without government control and management.

In conclusion, the budgetary and fiscal crisis right now has made many political issues far clearer in people's minds. The debt dilemma is a challenge and an opportunity to set America on a freer and potentially more prosperous track.

And in conclusion, Mr. Chairman, I would just like to give the following quote from a former President of the United States, with your permission:

"I place the economy among the first and most important virtues and public debt as the greatest of dangers to be feared. To preserve our independence, we must not let our leaders load us with public debt. We must make our choice between economy and liberty or confusion and servitude. If we run such debts, we must be taxed in our meat and drink and our necessities and comforts and our labor and in our amusements. If we can prevent the government from wasting the labor of the people under the pretense of caring for them, they will be happy."

Whose words are those, Mr. Chairman? Thomas Jefferson, the third President of the United States. Thank you very much.

[The prepared statement of Dr. Ebeling can be found on page 38 of the appendix.]

Chairman PAUL. I thank the gentleman.

And I will now recognize Mr. Ely.

STATEMENT OF BERT ELY, ELY & COMPANY, INC.

Mr. ELY. Chairman Paul, Ranking Member Clay, and members of the subcommittee, I appreciate this opportunity to testify today.

The first two charts attached to my written testimony show the tremendous growth of the Fed balance sheet September 2008, which reached an all-time high of $2.7 trillion in assets last Wednesday. How much more will grow is anyone's guess.

As my testimony shows, almost all the growth in the Fed's liabilities has occurred in deposits in the Treasury Department and banks. Initially, the Treasury borrowed funds to lend to the Fed that the Fed then lent and invested in the financial markets. The later jump in bank deposits enabled the Treasury to reduce its deposits and borrowing. Bank deposits at the Fed rose to $1.54 trillion last month.

Exhibit 2 also has faced the steady growth of the Fed's other major liability, currency. The Fed has no control over the amount of currency outstanding, though. It is totally demand-driven.

Turning to the Fed's income statement, the Fed has been extremely profitable since 2008. Exhibit 6 shows how the Fed earned a $52.9 billion profit for taxpayers last year. Over the 2008–2010 period, the Fed earned almost $90 billion, more than all FDIC-insured institutions, and 2011 will be another extremely profitable year for the Fed.

A key public policy question is whether the Federal Government, through the Fed, should play such a substantial role in the credit intermediation business.

Turning to the Fed's independence, that independence in fact is a myth. The Fed is a creature of Congress, and it operates with the full faith and credit backing of the Federal Government. Key to understanding the linkage of the Fed to the rest of the Federal Government is to consolidate the Fed and Treasury Department's balance sheet. There are several merits in viewing this balance sheet on a consolidated basis.

First, the asset side of the balance sheet shows the extent to which the Federal Government, through the Treasury and the Fed, is supplying credit to the private sector, notably to finance housing and higher education.

Second, the liability side of this consolidated balance sheet shows that private sector funds, principally deposits by banks in the Fed, currently provide substantial funding to the Federal Government.

Third, the liability side of the consolidated balance sheet shows at the end of March currency outstanding accounted for 10.4 percent of the total Federal debt held by the public. This non-interest-bearing portion of the Federal debt has declined as budget deficits have forced the issuance of substantial amounts of interest-bearing debt

Given the magnitude of Federal budget deficits for the foreseeable future, the currency portion of the Federal debt will continue to decline. The printing press will not be a cure for funding unseen future deficits.

In sum, the Fed could be folded into the Treasury Department tomorrow. Doing so would permit a unified management of the Federal Government's balance sheet. The Treasury could also assume the role of lender of last resort. Since the Fed, when acting as an emergency lender, is lending taxpayer dollars, it is not doing anything that Treasury itself could not do. Treasury's assumption as lender of last resort would bring much greater political accountability to such lending.

Since folding the Fed into the Treasury will not occur any time soon, Congress should mandate that the Treasury Department periodically produce a consolidated balance sheet of the Fed and the Treasury. This would present a more complete picture of Federal finances and the impact of the Federal Government on the U.S. economy.

Finally, the fundamental premise of central bank independence is that monetary policy should be free of political interference. Leaving aside the merits of that premise, the key question is what constitutes monetary policy.

Today, it consists solely of the Fed trying to influence interest rates through its open market operations, specifically to hold the overnight Fed funds rate as close as practical to the Federal Funds Rate Target, or FFRT, that is set by the FOMC.

The Fed does not control the money supply. The amount of currency in circulation is totally demand-driven. Money, however defined, is merely that portion of the credit supply which serves as media of exchange.

Inflation in the modern industrialized economy is to a great extent a function of the price of credit. If credit is underpriced, inflation may emerge as increased demand stimulated by underpriced credit causes the economy to overheat and asset prices to soar, as we saw in the recent years' housing bubble. Overpriced credit has the opposite effect.

Given that monetary policy is all about interest rates, the question is, who can better set interest rates: a committee of government bureaucrats; the FOMC; or the financial market? The experience of recent years certainly does not support the notion that bureaucrats can do a better job than the financial markets in pricing credit.

This question could be posed another way. What is it about credit that makes it desirable for government to determine its price? Somehow, either the central bank must provide a so-called nominal anchor for the credit market, a pricing benchmark, if you will. In the United States, that would be for the Federal funds rate target.

In my opinion, a good case has never been made that the financial markets cannot set interest rates across the entire yield curve that will promote stable, non-inflationary economic growth while minimizing the emergence of asset bubbles. More specifically, there certainly is no reason why the interbank lending market cannot establish and vary the overnight interest rate, which the FOMC now establishes through its open market operations.

I encourage the subcommittee to address the question of why interest rates need a nominal anchor, why it is in the public interest to have a government committee signaling what its members consider to be the appropriate level of interest rate, and why the Fed should try to enforce that signal through open market operations.

If that case cannot be made, then the primary raison d'etre for the Fed disappears, which would lead to folding the Fed into the Treasury Department.

Mr. Chairman, thank you for this opportunity to testify. I welcome the opportunity to answer questions.

[The prepared statement of Mr. Ely can be found on page 48 of the appendix.]

Chairman PAUL. Thank you very much.

And finally, we will go on to Dr. Slaughter.

STATEMENT OF MATTHEW J. SLAUGHTER, ASSOCIATE DEAN, TUCK SCHOOL OF BUSINESS, DARTMOUTH COLLEGE

Mr. SLAUGHTER. Chairman Paul, Ranking Member Clay, and members of the subcommittee, thank you very much for inviting me to testify on these important and timely issues regarding America's monetary and fiscal policies.

In my remarks, I will make two points regarding the relationship between the Federal Reserve and Federal Government debt. I will then make two broader points regarding the debt ceiling.

First, it is important to emphasize that the Federal Reserve purchases of Federal Government debt has for decades been standard operating procedure for how the Fed conducts monetary policy. In pursuit of its dual mandate of both price stability and full employment, in the normal course of operations the Fed has long bought or sold Treasury securities to increase or decrease supply of what is commonly called high-powered money, or the monetary base.

In turn, through rounds of lending in the private financial system, these changes of the monetary base affect the broader U.S. economy. Indeed, for many years before the world financial crisis, the Fed executed monetary policy almost exclusively by transacting Treasury Securities. There is nothing inherently nefarious or worrisome about the Fed owning a large amount of Federal Government debt.

Second, it is important to emphasize that the current fiscal challenges facing America have not been caused or abetted by the historic interventions the Federal Reserve undertook amidst the world financial crisis. The Fed's efforts to restore liquidity and stability to America's capital markets required it to expand both the size and asset composition of its balance sheet in unprecedented ways.

This historic expansion of Federal Reserve monetary policy did not somehow cause the commensurate historic fiscal expansion. Rather, massive Federal fiscal deficits were triggered by a combination of sharp downfalls in Federal tax receipts and especially sharp increases in Federal spending.

Thus, historically, monetary and fiscal expansion coincided, but neither directly caused the other. Rather, both have been directed at containing the damage to the real economy of the world financial crisis.

Let me now turn to the broader issue of America's looming debt ceiling. Here I would like to make two points, the importance of which it is difficult for me to overstress.

First, the decision to lift the debt ceiling is a necessary consequence of previous decisions on taxes and spending. If America does not want to default, then raising the debt ceiling is mandatory, not optional. Pick whatever deficit reduction plan you like—that of the bipartisan deficit reduction panel, that of Congressman Paul Ryan, that of President Obama. No matter which plan you like, that plan will expand total Federal debt outstanding by several trillion dollars over the next decade.

This means that no matter which plan you like, to see it become a reality without the United States defaulting, you must support increasing the debt ceiling.

My second and final point is to implore you to understand that America is tempting a crisis of unknowable proportions if we default on our Federal Government debt. In many ways, global capital markets today remain deeply impaired. Housing prices in the United States continue to decline. Several sovereign debtors in Europe are struggling to remain liquid and solvent. Central banks continue to provide extensive support to the global financial system.

At the same time, economic recovery remains tentative in the United States and in many other countries, as Chairman Paul indicated in his opening remarks. About 25 million Americans remain unemployed or underemployed. Today's 108.9 million private sector jobs is the same number that America had nearly 12 years ago.

Amidst all this fragility and uncertainty, the prospect of a U.S. Government default is truly frightening. As the recent past so painfully demonstrated, financial crises often arise from unexpected sources and metastasize in unknowable ways. And a default in U.S. Treasuries, rather than on some other debt security in the world, would be especially worrisome for two important reasons.

One is that U.S. Treasuries are the one asset that world investors generally regarded to be free of default risk. But there is no law of physics that states the world's risk-free asset will always be U.S. Treasuries. Indeed, it was not always so.

The other reason is that America's creditors are increasingly foreign, not domestic. Thanks to ongoing low saving rates by U.S. households, the foreign holdings of U.S. Government debt are likely only to rise beyond the recently crossed the 50 percent threshold.

History shows that deeply-in-debt sovereign powers are more likely to encounter sudden loss of confidence, the larger is the share of their outstanding debt held by foreign creditors. These fiscal crises have often come sharply and with little warning. All is okay, all is okay, all is okay. And then one day, all is catastrophically not okay.

America's fiscal challenges are grave. We need the understanding of our creditors to overcome these challenges. As such, America should be doing everything in its power not to cast doubt on the pledge to honor our debt. Time is running short, and what America needs most of all is leaders, such as those of you on this committee, to raise America's debt ceiling as part of meeting our fiscal challenges.

Thank you again for your time and interest in my testimony. And I look forward to answering any questions that you may have.

[The prepared statement of Dr. Slaughter can be found on page 66 of the appendix.]

Chairman PAUL. Thank you.

I will start the session for questioning. I want to follow up on Dr. Slaughter's position, on what would happen if we don't raise the national debt.

I concede it will be a problem and there would be some consequences, but the reason I come down on the side of saying that we shouldn't continue to do this is that we have embarked on a course that will lead us to such a consequence that will be much worse than not facing up to the fact that we just can't continue to do this constantly. There has to be some pressure put on the system that we can't depend on the creation of new money to accommodate the deficits that we come up to.

And I would like to ask Dr. Ebeling and Mr. Ely and let Dr. Slaughter respond, if he would like to, how bad is that if this debt limit is raised? And is there an argument made that it might not be nearly as bad as they suggest? They were panicking us now and saying that anybody who would suggest this is the equivalent to a terrorist suggesting that. And that came from a Republican.

So can you comment on that, Dr. Ebeling?

Mr. EBELING. Yes. I don't think that it has the danger that has been suggested. As I said in my comments, both in my opening remarks and in my written remarks, the U.S. Government certainly takes in enough tax revenue far and above the tax revenue necessary to meet interest and rollover costs of existing debt.

What would be required, if one is going to maintain one's international creditworthiness in that manner, is to start cutting back on other domestic spending other than one's debt obligation.

Will that necessarily require trimming, cutting, reducing a variety of current expenditures that the U.S. Government is committed to? Yes. But the fact is that the same thing applies to households.

If a household finds itself in the situation where it cannot afford, because it has reached its credit card limit, to add to this debt without serious problems, and is threatened with default if you can't meet its minimum payment, it then tightens its belt, and to decide maybe not to buy the flat screen TV for the extra bedroom for a while, maybe not to go out to the restaurant 2 or 3 times a month, and maybe to watch more on Netflix for the $14 a month as opposed to going to the movie theater for $15 a ticket.

And that is how it will have to be managed. Now, as I say, this is an important—

Chairman PAUL. Excuse me. I want to follow up, because you have emphasized the need to cut back, and you suggested where it would have to be.

Mr. EBELING. Right.

Chairman PAUL. And it would not be all that much comfort for the people who have to cut back. But can't you include in there how rapidly could we cut some of the spending that we do overseas and some of this foreign policy adventurism? Wouldn't that be a place that we could save some money as well?

Mr. EBELING. I totally agree with you. The fact is that even in the post-Cold War era, the United States has dozens upon dozens of military bases and facilities around the world. Tens of thousands of American servicemen—Army, Navy, Air Force, Marine Corps—are stationed in various numbers in many, many countries around the world.

I see no reason why we could not significantly cut back on this overreach in our foreign policy and bring those soldiers home, reduce our expenditures for those bases, and make the countries that have for decades had this umbrella of military security from the United States shoulder these expenses themselves.

The fact is the United States still provides a huge military umbrella for the European Union, which they have had a free ride on practically since the beginning of NATO. I see no reason why we couldn't cut back and expect them to defend themselves more effectively. And the same thing applies to Korea or Japan.

Chairman PAUL. Let me get Mr. Ely's comments, too.

Mr. ELY. Mr. Chairman, I am clearly concerned by what the present trajectory of spending is and, more importantly, what this means in terms of the ratio of Federal debt to GDP. It is reaching astronomical heights.

And the challenge that Congress faces is basically not only trimming the spending, but getting the economic growth we need to help bring down the relationship of Federal debt to the current GDP. And, of course, as everybody knows, entitlements are a key aspect of that problem.

I am one who draws Social Security and is a beneficiary of the Medicare program, which, of course, are tow of the really serious long-term problems facing the Federal Government. And they have to be addressed.

As much as I am—as I say, I am a beneficiary of those two programs. I fully appreciate, and I think even many of my fellow seniors do, that this cannot continue indefinitely. I do not envy the 30-year-olds and the 25-year-olds and so forth just now coming into the workforce because of the accumulation of these debts.

So it is going to have to be addressed, but it has to be more than cutting at the margin. It has to be some really fundamental changes and trimming back of the basic entitlement program.

Chairman PAUL. My 5 minutes is up, but I hope to be able to give you a chance to respond as well in time, so I am going to move on and recognize Congressman Frank.

Mr. FRANK. I agree on the need to cut back America's overcommitment internationally. I would say to Mr. Ebeling that, one, you said NATO has been getting a free ride practically since the beginning. No, not practically, no—since the very beginning.

Look, in 1949 we had countries in Western and Central Europe that were poor and devastated—enabled by his method to mobilize it all into military. And so the United States stepped in.

Two of those elements have changed. Western and Central Europe is no longer poor and weak and defenseless. There is no more Soviet Union menacing them. The only thing that hasn't changed is the American military protection. So, yes, there is a lot that could be done to shave that.

But—and I think this is true elsewhere in the world—Afghanistan. We are being told by some we should stay in Iraq another year to be the political and religious referee for Iraqi—but that is one of the points I want to make first of all.

The way this debt limit issue has been framed, I have had people acting—frankly, some of my Republican colleagues—as if they would be doing me a favor by raising the debt limit. The Federal Government doesn't owe me any money. I am not involved here.

I didn't vote for the war in Iraq. I didn't vote for the tax cuts of 2001 and for their renewal. I didn't vote for an unfunded prescription drug program. If everybody voted the way I did, we would have another couple of years before we would have to raise the debt limit.

Now, I lost. We incurred those debts. So that doesn't mean they don't pay them. But this notion that somehow I am responsible, that people on our side are responsible, no, there was a joint responsibility.

Let me just ask, though, Mr. Ely, in your response, the chairman had asked, and Mr. Ebeling responded, about what the consequences would be of not raising the debt limit. You didn't get to that. Would you tell me what is your view? Should we raise the debt limit? What if we are unable to come to a formula and don't raise the debt limit and run into the problem of not being able to—what do you think the consequences of that are?

Mr. ELY. I think it depends on how long things would go on before there was either resumption of the payment of the debt or at least the interest on the debt. If it is something that lasted a couple of days, I think—

Mr. FRANK. Okay. But if it is a couple of weeks or longer?

Mr. ELY. A couple of weeks or longer, I think could create some very serious longer-term negative consequences for the Federal Government in terms of leading to higher interest rates on Treasury debt. Again, I think it comes back to how does the financial—

Mr. FRANK. Yes, I am sorry, but I only have 5 minutes. I appreciate, but you—so you do think an indefinite problem. I agree that 1 or 2 days is never much of a problem. But if there is real uncertainty about how we are going to do that and it goes on for a while, there are negative consequences.

Mr. ELY. Oh, there is no question that there will be. And those negative consequences will mean higher interest rates on the Federal debt, and that will add to the budget deficit, if it goes on for a long time. A couple of days—

Mr. FRANK. Yes, if you don't have a resolution, yes, again, nobody thinks 1 or 2 days is a problem. We can do anything around here for 1 day except maybe hold our breath. But if you start getting into a deadlock, it is a different story.

Mr. Slaughter, you served in a very important position during the previous Administration, the Bush Administration. Again, on the debt limit, I appreciate your coming here and sharing your view.

What was the general view in the Bush Administration of the President and other high financial officials at Treasury and elsewhere, about the consequences if we were unable to come to an agreement on raising the debt limit?

Mr. SLAUGHTER. I think there was a variety of views, but I think almost everyone recognized that the unique position the United States has in global capital markets where Treasuries are regarded as the risk-free asset, everyone reasonably knew to have the humility to not know what would happen if we jeopardized that.

If we were to breach the debt ceiling and not have a resolution for some period of time, it is really difficult to know what is going to happen to demand for Treasuries around the world. We have never lived in that world. And again, today, now of the roughly $10 trillion in U.S. Federal debt that is in public hands, slightly over half of it is foreign-held.

Mr. FRANK. Let me just a quick question, because you have been to business school. What about American businesses that operate internationally? Is there some negative impact for them, the multinationals that have to operate across national—

Mr. SLAUGHTER. There absolutely is. The global corporations, they have long time horizons, and when they discuss seeking certainty for the key investment and job creation decisions they make, the kind of uncertainty that we create in not resolving the debt issue makes them look outside of the United States to create those jobs.

Mr. FRANK. Mr. Paul and I can persuade our colleagues that we are spending hundreds of billions over time unnecessarily. By the way, we are defending wealthy nations against nonexistent threats. If we just started to bring some of that home, we can do some good work.

I thank you, Mr. Chairman.

Chairman PAUL. I thank the gentleman.

And I now recognize Mr. Huizenga for 5 minutes.

Mr. HUIZENGA. Thank you, Mr. Chairman. And I wanted to continue your line of questioning.

Dr. Slaughter, if you care to comment briefly on what Chairman Paul was asking before he ran out of time.

Mr. SLAUGHTER. Sure, I would add just a little bit of data. Again, there is about $5 trillion of the $10 trillion in U.S. debt outstanding in public hands that is now held by foreign entities. We don't have great data on who is holding U.S. Treasuries and what the source of their demand is. That is the reality of how data is collected globally.

Most people think that the People's Bank of China, which is the Chinese central bank, is the single largest entity holding U.S. Treasuries outside of the United States at about $1.5 trillion. A lot of both the private and public institutions are holding Treasuries, we think, because of the perceived safety of that asset.

And safety is not something you can measure like you can measure things in the physics laboratory. What is saved in the eyes of these international investors is up to them, in large part. And so whether it is a 2-day breach, whether it is a 2-week breach of the debt ceiling, what is sort of mandated or chosen liquidations of holding U.S. Treasuries, it is hard to predict.

And it is hard to predict, then, as Bert said, what is going to be the impact on interest rates in the United States and that stress more generally on world capital markets that in many ways remain quite strained. And frankly, I think it is important to keep in mind financial crises are almost by definition hard to predict what would be the exact causes of them and hard to predict how they will evolve through time.

Mr. HUIZENGA. I appreciate that. And I wish our former chairman hadn't left. I was scarily going to say that we might be coming from a similar spot here. I am a freshman. I haven't been involved here on the run-up on our debt either, as his claim was, but we certainly have a position here—I have a position here of my desire to stop spending.

And that, I think, is how, if we hear from some of our friends on the other side of the aisle, who argue, "I wasn't part of that problem, because I didn't vote for this or that," I am here now, and I believe that part of that solution, exactly as Dr. Ebeling is talking about, is stopping our spending.

So it seems to me that is a fiscally responsible thing to do, as we are moving ahead, because I have a fear that, too, also, Dr. Slaughter, if we are going to put our currency as the reserve currency of the world at risk and we are going to be looking at much of what has happened to many of our constituents, where they have had issues with their own personal credit and then had to go back and try to borrow more money, what has happened?

They are a greater credit risk, and they have had greater interest rates. We have seen this in Portugal recently. But I think our first and foremost focus needs to be on the stop-spending part. And I am curious to hear a comment there.

And then also, if anybody cares to comment on the value of the U.S. dollar, as opposed to the other currencies of the world and what we have seen in the rise of those other currencies or maybe more accurately a fall of our value.

Mr. ELY. If I could jump in here, again, I think a key aspect of the attack on spending has to be on the entitlements, has to be on money that people my age and older and even younger now are getting under Social Security and Medicare. And particularly, as the boomers come onto Social Security and Medicare, the problem is going to grow. And I think that is a very tough political issue that you have to deal with.

There is also the question that I know came up before, and that is about the savings rate. America is the world's largest debtor nation, somewhere in the range of $3 trillion. And I think a key aspect of our poor financial situation isn't just the Federal debt, but it is the overall position of the United States with the rest of the world.

I know there are folks in the Pentagon who are concerned about our net debtor position, because the key reason why foreign interests hold so much in Treasury is because as a country, as a whole, we are so deeply in hock to the rest of the world.

So domestic savings and trying to encourage a greater level of domestic savings is, I think, a very important element of dealing with our global situation.

Mr. HUIZENGA. Dr. Ebeling?

Mr. EBELING. Yes, if I can just make a couple of comments, the concern has been expressed, and I don't disagree that if the United States were to default on its debt, its interest payment, this would have significant ramifications for our creditworthiness, interest rates at which the Treasury could borrow and so on.

But let us think of the alternative. If, as the Secretary of the Treasury has recommended, the debt limit is increased by $2 trillion, then that will mean that between now and the beginning of 2013, the United States is likely, given the current trajectory, to need to borrow additional $2 trillion.

Now, it is very hard to believe that if the Federal Reserve does not increase the money supply, that will not eventually have an effect of rising interest rates anyway because of the amount of money that is going to be sucked into the government's deficit spending either domestically or from the international financial market.

There is also the fact that if the Fed monetizes it, as could happen as well, and as I was suggesting it has already done to a great extent, that will start having even more inflationary effects as the money starts percolating through the economy. And eventually, as people develop inflationary expectations, interest rates will rise anyway as they put an inflation premium on the rate of interest. So the fact is that it is between a rock and a hard place.

Mr. HUIZENGA. It is inevitable, is what you are saying?

Mr. EBELING. But in the long run, the important thing is that the government's budget has to be put under control. And the starting point, in my view, is that we do not raise the debt limit. We get our financial house in order now and start cutting and trimming spending so as to meet our financial obligations, but start taking our medicine to get on a sound financial course.

Mr. HUIZENGA. Dr. Slaughter, would you like to comment on that?

Mr. SLAUGHTER. I agree with many of the previous comments on the need for the United States to address both its medium- and long-term fiscal challenges. Our fiscal trajectory is completely unsustainable. I don't anticipate getting any Social Security, quite frankly.

Mr. HUIZENGA. I am 42, and I will be shocked if I get any.

Mr. SLAUGHTER. I am also 42, and my wife is the house accountant. I am the household trash recycling guy, but that is how we do it.

But that said, with no disrespect to anyone here or the broader U.S. Congress, I just don't see how these deep challenges of spending and savings choices both for America overall and for the Federal Government can be addressed, frankly, in the next few days or few weeks without having major damage done to the creditworthiness of the United States if it breaches—

Mr. HUIZENGA. Are you implying that maybe we don't have the political will to go out and do some of the things that we need to do?

Mr. SLAUGHTER. I am saying it is a really complicated set of issues and trade-offs that our country faces about what—

Mr. HUIZENGA. Because I would say I don't believe we have the political will to go out and do what probably most people believe we need to do.

Mr. SLAUGHTER. In which case, I am just very concerned about how the policy conversation proceeds and what happens in global capital markets. That timetable of global capital markets is not one that anyone in the United States controls.

Mr. HUIZENGA. Would anybody care to comment?

My time has expired. So thank you, Mr. Chairman.

Chairman PAUL. The gentleman's time has expired. And if you hang around, we might be able to get some more questions later.

Now, I recognize the ranking member, Mr. Clay.

Mr. CLAY. Thank you, Chairman Paul.

Dr. Ebeling, the President's deficit reduction commission recommended numerous items of reining in spending. Also, they addressed a fair tax proposal. You have mentioned several times that we need to reduce spending. Should some type of tax reform be a part of that equation also?

Mr. EBELING. With all due respect, Congressman Clay, I think there needs to be tax reform, but the reform has to be taking the longer view—cutting taxes, not raising them. I believe that all across the income spectrum, Americans are paying more than enough taxes for what government does.

The fact is, it is not a taxing problem. True, the taxes have fallen because of the recession, but it is not a taxing problem. It is a spending problem.

The Congress, the President, too many special interest groups, and the general environment of the country have become addicted to the idea that the U.S. Government can afford and has the ability to hand out more and more largesse to society in general, to various special interest groups, for which the money and the resources are not there.

It is a spending problem, not a taxing problem. You don't want to raise taxes—

Mr. CLAY. Right. We have—

Mr. EBELING. —and create disincentives for work, savings, and investment, which in the long run doesn't make the economic pie get bigger. If you raise taxes, you slow down the pie's growth potential.

Mr. CLAY. You have mentioned the accumulation of U.S. debt over the past 3 years. What was the accumulation of the U.S. debt over the past decade?

Mr. EBELING. I am here at one level as someone who is not wearing a political hat. I am an academic economist. That means I try to look at the truth. And the Republicans were unbelievably irresponsible.

As I mentioned in my written testimony, between 2001 and 2008, our national debt doubled from approximately $5 trillion to $10 trillion. And therefore, they were as responsible, as I think the present situation is, with an unwillingness to cut government spending to bring this danger to a close.

Mr. CLAY. Okay.

Mr. EBELING. So, no. Both hands have a little bit of dirt on them.

Mr. CLAY. There are no clean hands. You are correct.

Dr. Slaughter, has the Fed policy of quantitative easing helped to improve the economy over the past 18 months?

Mr. SLAUGHTER. Yes, I think it has. I think both phase one and phase two were an attempt to continue to stabilize U.S. and global capital markets. I think they largely succeeded in that.

In particular, quantitative easing two was put into place at a time in mid- to late 2010 when there were a number of signs that the U.S. economy's rate of growth was slowing and that the general level of prices was coming close to being flat to falling, and so the need to try to avoid deflation, which can be very corrosive and as the Japanese experience over the past many years has demonstrated can be very difficult to overcome, it was important to avoid that outcome.

That said, as Chairman Bernanke himself said in his press conference recently, the Fed can't solve all the systematic challenges that face the United States, and in particular trying to get economic growth going again and get the job creation and income growth that America needs.

The Fed, simply over the medium- and long-term, can't create those jobs and can't create those rising incomes. That largely comes from the private sector. And so the policy conversations we need to have, I think, need to focus on what it is to incite job creation in the private sector.

Mr. CLAY. Earlier this week, Speaker John Boehner offered up a $2 trillion cut in exchange for raising the debt ceiling. And with the conditions being as they are on Capitol Hill, with a split Senate and a House, what is the likelihood of actually resolving this, if we have a protracted battle over this, over raising the debt ceiling? Or what would be the consequences of it?

Mr. SLAUGHTER. Again, part of the challenge I would stress is I don't exactly know how and where the consequences will arise. But if we miss an interest payment or we miss a principal repayment because the United States is not able to re-channel some of the incoming tax revenue away from current spending obligations to making good on interest and/or principal payment, it is difficult to say how credit rating agencies will respond.

It is difficult to know what both domestic and foreign creditors to the United States, how that might cut back on their demand for U.S. Treasuries.

I would stress again that financial crises by definition are hard to know how they arise and hard to know how they develop, so I think it is incumbent on people to realize as fragile as the world's financial system and the U.S. economy remain today, going in that direction carries great risk.

Mr. CLAY. Thank you for your responses.

Mr. Chairman, I am out of time.

Chairman PAUL. I thank the gentleman.

I recognize Mr. Luetkemeyer for his 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

I would like to ask a question of Mr. Ebeling, probably, with regards to interest rates and the end of QE2 this summer. What do you think is going to happen when we quit absorbing all of our debt? Do you think that the rest of the world has enough liquidity in it to purchase our debt? And if so, at what interest rate do you think would be able to have that done?

Mr. EBELING. I am not sure if there is enough liquidity in the global economy to make up the difference of what the Fed has been doing in increasing the money supply to help finance the government borrowing. I think that inevitably when the Fed ends its QE2, as it is saying in June formally, that means we are going to be relying upon what the financial markets—what the fixed amount of funds in the financial markets can do at home and any money that might be lent to us from abroad.

I will be surprised if looking over the next year, the Federal Reserve does not go on a monetary expansionary policy again if we don't start seeing interest rates rise.

Of course, there could be political crises in other parts of the world where everyone runs to the United States as a traditional shelter to park their money. But presuming that does not occur, I would be very surprised if the Fed does not become accommodative again, if interest rates don't start nudging up.

It was pointed out earlier by Mr. Slaughter, and I agree with him—or I believe it was Mr. Ely—that savings rates have been very low in the United States. The fact is, according to the St. Louis Federal Reserve in their monthly monetary trend publication, since the last quarter of 2009, when adjusted for inflation, the Federal Reserve has pushed interest rates so low, such as the 1-year Treasuries and the Federal funds rate, that real interest rates are in the negative range, –2 percent.

It is not surprising, then, that when interest rates in whole are so low that you don't create much of an incentive for people to save. The fact is we have to allow the financial markets to tell us how much real savings is in the domestic economy and how much of the world economy has savings to share with us. And then on that basis, we can know what real interest rates should be.

And the United States, as I say, should cut back, eliminate its deficit spending so that the savings that is available, either domestically or from foreign sources, can help the recovery in the United States.

Mr. LUETKEMEYER. Okay. So it is your contention that the Fed, in order for us to continue to spend at a deficit level, will have to have a QE3?

Mr. EBELING. Whether they call it that or not, I don't see how $2 trillion more of borrowing over what amounts to the next year-and-a-half is going to be successfully provided by the global or the domestic economy alone.

Mr. LUETKEMEYER. And if it is provided, it would definitely be at a higher interest rate, I would assume. Would you agree with that?

Mr. EBELING. If it is accommodated by the Fed, interest rates may temporarily stay low. But as I was suggesting in response to an earlier question, the fact is that inflation will start nudging up even further, and inflation premium will go on the rate of interest, and we will not get away from it. And in addition, the value of the dollar will continue to fall on foreign exchange markets.

Mr. LUETKEMEYER. And there is another problem here as well. As interest rates go up, the cost of our monies go up, the deficit that we have is going to go up, which means all of the cuts that we make, all those stays we make in our budget are going to be eaten up by increased interest rates.

Mr. EBELING. Correct. This is the dilemma that is facing those peripheral European countries, as they are called, such as Greece and Portugal. On the one hand, they are trying to carry out what they call austerity programs, but the international creditors don't have confidence in them, so it is time for them to rollover or pay off debt, and the new interest rates are even higher, which immediately reverses or cuts into the attempt to get their budget under control.

Mr. LUETKEMEYER. Okay. Let us leave it at—

Mr. EBELING. It has to be believable.

Mr. LUETKEMEYER. I agree with you.

Mr. ELY. If I could just interject in here—

Mr. LUETKEMEYER. Yes, sir.

Mr. ELY. —there are many, myself included, who are concerned that interest rates, that nominal interest rates are too low and that what may happen is that before we know it, we will start to see asset bubbles emerge again and that the Fed will not respond quickly enough. And so what we will do is we will get an overshoot in terms of rising asset prices.

Now, that doesn't seem like much of a concern today, particularly when we look at where housing prices are, but in fact the Fed can't turn on a dime, in part because we don't know in a real-time basis what is happening out there in the market. So I—

Mr. LUETKEMEYER. I have one more quick question, if I can interrupt.

Mr. ELY. Okay.

Mr. LUETKEMEYER. Just with regards—I see my time is up. Okay. Thank you, Mr. Chairman.

Chairman PAUL. I thank the gentleman.

And I recognize the gentlelady from New York, Mrs. Maloney.

Mrs. MALONEY. Thank you.

And welcome. I would like to ask each of your perspectives on this question: Isn't it true that the real drivers of U.S. debt are not the Federal Reserve's monetary policy, but fiscal policy decisions that we have to face about congressional policy on entitlements, taxes, and spending?

I recognize that there has been controversy surrounding monetary policy decisions like the QE2 program, keeping the Federal funds rate at nearly zero percent to access to the Federal Reserve's lending window. But all of these programs are really temporary. And once the economy turns around, the Fed will exit from them.

And so I would like your comment on it. The title of the hearing, of course, is about the Federal Reserve policies and the debt ceiling, but I am asking whether you see it as Federal Reserve policies or really congressional decisions on spending and fiscal policy.

Mr. ELY. If I could jump in here, I think it is basically focused on fiscal policies. I am not going to blame the Fed for the situation that we are in. But this is going to be that tough issue of what do we do about fiscal policy.

I am not in favor of raising taxes. I think the entitlements have to be addressed, although I think in the context of tax reform, there should be greater incentives in place to not only save, but also not to borrow.

One of the problems we have in the economy is that the Federal Government, through the Tax Code, effectively subsidizes borrowing, and borrowing in the private sector did a lot to get us in the mess we are in now. But I think the key longer-term focus has to be on the spending side, and particularly on entitlements.

Mrs. MALONEY. Any other comments?

Mr. SLAUGHTER. I would agree with Mr. Ely. Yes, the debt problem we face today with the debt ceiling has been driven by fiscal policy choices, not by monetary policy choices. And again, as they go to the medium- and long-term, it is the projected increases in Social Security, Medicare, and Medicaid spending that are going to present the largest charges to the United States.

On the tax side, the one thing I would say is I agree raising tax rates is not great. When you are raising tax rates on income, that creates disincentives for work and effort. But there are a lot of inefficiencies in our Tax Code today. We could raise tax revenues without raising tax rates with simplifying the Tax Code in a lot of ways.

One example is the mortgage interest deduction. Another example is the tax advantage that is given currently to health care spending. The cost of both of those tax advantages in our current Tax Code are currently estimated to be north of $200 billion per year.

So as we think about innovative solutions to address these challenges, I think that is one thing to keep in mind is tax reform can be a great way to try to incent job creation and a lot of great things in the private sector, while also helping address the tax revenue challenge.

Mr. EBELING. It is a fiscal problem fundamentally. In this process, the Federal Reserve has been an accomplice during the fact in the sense that it has supplied the money to fund a lot of what the government has been borrowing.

But the bottom line is the burden is here in the House of Representatives, in the Senate, and in the White House. You are the ones who have the authority to tax. You are the ones who also have, more importantly, the authority to spend. And it is the spending side more than anything else that has to be handled.

This gap between revenues and expenditures, this deficit each year, has to do with the fact that you are promising the American people, in entitlements or other current annual expenditures, more than the economy is generating in the tax revenues, given the code that you have, and the economy's ability to generate wealth in the long run.

So the fact is it is a fiscal problem. And as I have suggested, the bottom line is—there is nothing wrong with, obviously, introducing efficiencies in the Tax Code in principle, depending upon the content and the specific character of it—but the bottom line is it is the spending that is out of control, not the taxing.

Chairman PAUL. I thank the gentlelady.

I recognize Mr. Schweikert, from Arizona.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

A slightly different question and what I have been trying to watch, as we go through this summer, and let us assume that we will call it quantitative easing goes into an unwind. Japan, being what, they hold about 20 percent of our foreign-held U.S. sovereign debt, has to do some unwind there to pay for infrastructure. Some of the tells coming out of China are true that they intend to do more moving of foreign reserves into commodity or commodity-based currency.

What happens at the end of the summer if we were to go just raise the debt ceiling, not having a series of triggers and mechanics and tells to the market that we are serious about this explosion of U.S. sovereign debt, and at the same time the very people who have been buying and financing our debt are not as big a participant in the market?

First, am I being realistic? Am I just being a "Chicken Little?" And if there is any truth in that scenario, what happens to interest rates on our debt? Anyone who wants to answer?

Mr. SLAUGHTER. That kind of scenario is eminently plausible. Again, there are a lot of investors around the world that hold U.S.

Treasuries today for a lot of complicated reasons, but they have a lot of other assets that they can choose from. That is true for the government-related entities, the central banks, and some fiscal authorities, but also the private savers in other countries as well, sovereign wealth funds, individual pension funds, things like that.

So their demand for Treasuries would depend, as you rightly say, a lot on whether they perceive the United States leadership as credibly addressing the fiscal challenges we face. So the sooner that we can credibly signal to our creditors that we are on that, the less likely it is that bond rates in the United States will go up with damages to the United States.

And the one thing I would add is I am struck at the heterogeneity in opinions that you see out there from a lot of the key investors in asset markets. To single out one particular gentleman, Bill Gross, head of PIMCO, publicly announced in the past couple of months that a lot of their key bond funds have totally divested of U.S. Treasuries.

Mr. SCHWEIKERT. And just a little bit of trivia on that, if you noticed their latest disclosure, they have actually increased their hedge again. They are basically hedging on the downturn.

Mr. SLAUGHTER. Yes, so that uncertainty, I think, is symptomatic of why I would urge caution and prudence on all these fiscal things, but especially get on not breaking the debt ceiling.

Mr. ELY. The key thing is that what you are suggesting and what is implied in your question is that there will be reduced demand for Treasuries from outside the United States. That has to have an upward effect on Treasury rates. And given the fact that we have so much in the way of short-term and medium-term Treasury debt outstanding, that starts to bite pretty quickly in terms of higher interest costs. So we are in a very dicey situation.

Mr. SCHWEIKERT. Mr., is it pronounced "Ely?"

Mr. ELY. "Ely."

Mr. SCHWEIKERT. "Ely," like the coffee?

Mr. ELY. Yes.

Mr. SCHWEIKERT. Okay. Are we also under a common understanding that our WAM is what, about 4.25 years?

Mr. ELY. I am not sure what it is right now. It has shortened up, I know, and, of course, the shorter the weighted average maturity of the debt, the sooner an increase in rates is going to whack the Federal budget.

Mr. SCHWEIKERT. It makes us very interest rate sensitive, which is—

Mr. ELY. Yes, it is. It is increasingly interest rate sensitive because of the shortening up. In fact, it is a very significant question as whether or not Treasury has properly managed debt, our Federal debt, so it is actually extend the maturity during this time of historically low interest rates.

Mr. SCHWEIKERT. You are actually hitting one of the things I was going to pitch at the end is maybe we should also in this environment, even though the outer end of the curve is a little bit steeper, but maybe we really need to start pushing out our maturities to insulate ourselves from shock.

Mr. ELY. I would agree, and actually we have gone the wrong way.

Mr. SCHWEIKERT. I want to pounce on just my scenario. Am I pitching a doomsday scenario? Am I pitching just a realist's on what essentially will drive up our interest rate?

Mr. ELY. In my opinion, your scenario is very realistic.

Mr. EBELING. I don't think it is unrealistic. I think the very points that you raise—the Japanese are going to have a huge financial cost to rebuild the destruction from the earthquake and the tsunami. The Chinese might very well lose their taste or their desire for U.S. Government securities. There is the question of the amount of savings to come into the United States to fund U.S. Treasuries, given the financial crisis in the European Union.

All of these things are creating serious problems looking over this year. But I think that this concern about what is the signal or the message that foreign creditors, either the private sector or others, sovereign wealth funds, for example, will read from this.

What will they read from it if you raise the debt limit by, for example, Secretary Geithner's request of $2 trillion, and this basically puts aside virtually any debate, discussion or decision about what to do for the budget between now and the next election cycle—that is, to 2013—and the uncertainty, to be honest, who is going to be the next President of the United States? Will it be the continuing current President or someone else?

Mr. SCHWEIKERT. Doctor—

Mr. EBELING. That will create a huge amount of further uncertainty on the financial markets and hesitancy about maintaining the value of the dollar in those markets.

Mr. SCHWEIKERT. Thank you.

And, Mr. Chairman, I know I am out of time, but one interesting conversation, I spent a couple of days in New York—actually, Monday and Tuesday—and I had a couple of folks who are huge buyers, are marketers in U.S. sovereign debt issues. And they said, "Look, we are going to punish you if you go and raise the debt ceiling and don't communicate to the markets that you are taking this seriously."

And every single point is what, $100+ billion bleeding. So even just moving back to normalized interest rates is devastatingly ugly to this budget. Thank you, Mr. Chairman.

Chairman PAUL. I thank the gentleman. And we will have a chance for a follow-up, if you care to stay.

I have a follow-up. I want to talk a little bit more about the consequences of not raising the debt limit. And I think even Dr. Slaughter admitted that he is not exactly sure—it wouldn't be good, but not precisely sure exactly what will happen, because it is unknown territory.

The question I have, Dr. Slaughter, is how do you answer the argument that others say why don't we, Treasury, just use priorities, pay the most important bills, pay the debt? Does that raise a lot of questions about our credit rating, if we always honored the commitment to pay the interest?

And, of course, we would still have a problem. We would have to pay our other bills slower. But wouldn't that protect the integrity of the credit?

Mr. SLAUGHTER. So that has a couple of costs, I think. One important cost is you are implicitly turning into creditors, involuntarily, Social Security recipients or government contractors. They are being made unwanted creditors to the U.S. Government to make good on outstanding—

Chairman PAUL. Maybe farm subsidies.

Mr. SLAUGHTER. Whatever it is, but the principle that I think a lot of holders of Treasuries look at is a sudden, on-the-fly change in priority of payments by the U.S. Government. That is going to introduce uncertainty and risk.

And I am not a legislative expert, but I just don't know. My understanding from what I have read up to learn about this is we simply don't have a set of rules and laws or executive orders in place to prioritize payments coming out of the U.S. Treasury when there isn't any existing law or regulatory structure in place to make those priorities—

Chairman PAUL. But okay, let us assume they can do it and they always honored the commitment to pay it. Would that mean that it would be less drastic than you anticipate? Wouldn't that soften the concern, if you knew that they put it into a form of a law and they said that you could do it? Would that soften your concern?

Mr. SLAUGHTER. No, not necessarily. The other issue I want to raise is the economic concern—again, the fragility of the recovery right now.

If we are talking about truly not raising the debt ceiling at all, the implied fiscal contraction that would come in the coming months from that, without offsetting policy support for economic growth of the private sector, so things like trade liberalization and other things, would have a very bad impact on jobs and the labor market in the broader U.S. economy.

Chairman PAUL. A concern I have sometimes is the crisis is very often overblown. In 2008, it was a major crisis. We didn't do it. We are going to have a grand depression.

But what we did was we had TARP funds and we had the Federal Reserve pumping trillions, and everybody said, "See? We saved ourselves from a depression." Maybe Wall Street didn't get their depression, but the people got the depression. They lost their jobs and they lost their houses.

So I can't see how ringing the alarm bells and doing it just because something terrible might happen—maybe doing it will make things worse. And I think what we are doing will eventually make it worse. You had another comment on it?

Mr. SLAUGHTER. I guess my concern is I would express again the unknowability of how capital markets are going to react to a breach of our debt ceiling.

And I would stress again part of the challenge in the fall of 2008 was how quickly the crisis with Lehman Brothers and AIG and capital markets metastasized to the General Electrics and other firms that were not able to rollover their commercial paper. And we were looking at layoffs several million more potentially than what we actually saw.

Chairman PAUL. But we don't know. It might even boost confidence to say, "Hey, they are going to get their house in order." It might even give more integrity to the dollar, and then we wouldn't have the crashing dollar.

Bert?

Mr. ELY. If I could just add something to that, there has been this discussion of we will pay the interest, but not repay the principal. In effect, what that is is a forced rollover of the debt.

Now, if you take Treasury bills, bills get paid off because the government sells new bills. If you say, "Okay, we are not going to pay off the bills as they are maturing," effectively, that has the same cash flow effect for the Federal Government as paying them off and rolling them over. So nothing is gained, in my opinion, by delaying the payment of maturing debt.

But the effect of paying on the markets, of not paying off maturing debt I think would be catastrophic, because people, particularly institutional investors, have cash flow programs that are based on known maturity dates for their debt.

If they don't get it, it may actually cause severe financial problems in some circumstances, but certainly really rattle the market. So I think one option that is, as a practical matter, not on the table is not paying debt as it matures.

Chairman PAUL. Of course, the other side of the argument is what we are looking at is something even more catastrophic with an inflationary blow-off, and that can be very, very tragic.

Dr. Ebeling, did you want to make a comment on that?

Mr. EBELING. I do. I think that the soundest policy, the one that would send the right signals to our international creditors, to set a tone in the United States, is precisely to say we will meet our financial obligations as interest and securities become due and that we are going to adjust our domestic spending to assure that.

The fact is, obviously, nobody wants their ox to be gored while others don't. But it seems to me that if we had the political will, which means the Members of the Congress make these decisions, to say that we are going to meet our financial obligations on the debt as they come due, but we are going to be reducing spending across the board by 5, 10 percent to see that it is covered without getting an increase in the debt limit, certainly, that sends the right signals internationally.

And it makes every American realize that nobody is getting a cut that they are not—well, that another person is, and that everyone has to bear the burden of this precisely because the promises have been greater than the tax structure and the economy can sustain.

I think that if it is across-the-board, it is very difficult to say that someone is getting something of a deeper cut or burden compared to someone else.

That requires political commitment and willingness to do it as well, but what else are you going to do? Do you want to be in this situation, maybe not today? You could raise the debt limit. You could put it off 2, 3, 4 years. But do you want to be put in the position in our own circumstances of a Greece or a Portugal? Eventually, you cannot keep this going.

Chairman PAUL. Right. My time has expired.

Now I am going to recognize the gentleman, Mr. Luetkemeyer, from Missouri.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

The reason for my question a while ago was we had a discussion with Chairman Bernanke in this committee at one point, and, obviously, you gentleman answered the question the opposite of the way he did, which is not surprising.

Another question for you with regards to the discussion we had with him with regards to the Fed and their policy, he made the point during the discussion that with QE2, look at how great the stock market is. It has all gone up.

And my concern is, I am not sure you can use the stock market as an indication of the strength of the economy, when you are looking at 9 percent unemployment.

Can you tell me the relationship between the stock market and our economy, the jobs, Fed policy? Can you kind of put it into—that is a broad thing to talk about in just a 30-second sound bite, but it would seem to me that I think the stock market is an institute unto itself. It is a daily reaction to what is going on in the world versus a long-term thought process or process on long-term thinking about really where our economy is going.

Would you care to comment or give me some thoughts on it? And we will go right down the line. I would like to have everybody's comment.

Mr. EBELING. I think that what we have seen for the last 2½ years with this huge run-up in the stock market has basically been due to Fed policy. It is not due to anything of a natural and normal recovery in the economy, which has been delayed by, as I also mentioned in my written remarks, regime uncertainty.

The fact is the economy was thrown out of the severe imbalance due to the monetary expansion and interest rate manipulations of the bubble years from 2002 to 2007. And it is necessary for these misallocations of resources, investment mistakes, to sort themselves out.

But the fact is that instead of allowing the market to properly correct, the Fed bought up these mortgage-backed securities and distorted the housing market. What are houses worth? Nobody knows. We think they are at the bottom. But what do we know about the real supply and demand?

So there is uncertainty in the housing market. This has affected the construction industry. The fact is the ones who have benefited are some people in the stock market and in the financial market.

If you break down the government statistics that have been coming out every month about GDP and employment figures to sectors of the economy, as 2008 and 2009 rolled on, you saw falling employment in virtually every sector of the economy except the one. If you look at the little sectoral breakdowns, that was the financial market.

It seems that no one from the top to the teller in the retail bank office lost their job. And that is because the Fed basically bolstered the financial market for their bad decisions, which they felt confident would be bolstered because of expected bailouts. And it has fallen upon the rest of the economy while the economy has not been left alone to properly adjust.

Mr. LUETKEMEYER. Thank you.

Mr. Ely?

Mr. ELY. The stock market is based on—and values in the stock market are based, as much as anything else, on expectations. What are future earnings going to be and future dividend levels? And so the market tends to be a leading indicator in a crude way of where the economy is going.

But the market doesn't always get it right. It tends to undershoot and overshoot. And the real question is, how has the market gotten ahead of itself, given some of the factors that you pointed out, such as the very high unemployment rate?

Ultimately, the stock market has to reflect the real economy, and the fact is we have a weak economy. The unemployment rate is still at very high levels. We are running these huge deficits, as we have been talking about here. So it may be a situation where the market is ahead of itself, and that is why I don't think we ought to place too much emphasis on where the market is and focus more on what is happening in the real economy.

Mr. SLAUGHTER. That is a great question. There is a positive effect from stock market valuations to the broader economic performance, but it is not lockstep, and it is not what drives economic performance overall.

You can look at the balance sheets of households. Only about half of households own any equities directly or indirectly. And for the median household, the single biggest asset on its balance sheet is the equity it may have in its home. The home prices matter a lot more for the typical family. And for income statements for most households, it is to have a job and what is their earnings for that job.

If you look at the recovery, a lot of the publicly traded companies, a lot of them, the revenue growth such as they are realizing, if any, is coming from outside the United States. It is the Caterpillars and the Deeres and companies like that reporting huge revenue growth around the world, especially in emerging markets.

So I think the challenge that you rightly point to is how can we get job creation in America? We need it from all kinds of companies now, U.S.-based and foreign-based. We need it from big and little companies, but creating jobs linked especially to exports and investment opportunities around the world, not as much as we have been discussing, the things like consumption spending in the United States.

But if you look at—that comes back to, in part, the fiscal conversations we are having in this hearing. If you look at recent surveys of small business owners in the NFIB, the single biggest problem that a lot of these firms cite is there is some combination of poor sales, but also government uncertainty, uncertainty over tax rates and government regulation.

Mr. LUETKEMEYER. Okay. I see my time is up, but I want to thank you gentlemen for being here.

It seems as though there is an underlying theme through all of this, and it is confidence in the ability to get our economy going. It is confidence in the ability of the Fed to manage. It is confidence in the ability of financial institutions to work back and forth and believe that they are going to be able to get their money back when invested.

As somebody in the financial industry, the whole thing is held together by confidence, believing that we can do business with each other and be able to get our money back. I think we have a huge confidence problem right now.

Thank you, gentlemen.

Thank you, Mr. Chairman.

Chairman PAUL. Thank you.

I now recognize the gentleman from Arizona, Mr. Schweikert.

Mr. SCHWEIKERT. I love this, where I can get another question this quickly, Mr. Chairman.

Back in sort of the circle I was trying to—and I appreciate you indulging me, because I have been trying to get my head wrapped around some of this—how much of a benefit do you believe we have had? Because I am looking at the short end of our interest rate curve right now and we basically have free money. And if you look at also throw a little inflation on top of that, it is almost people are giving us money and almost taking a hit on it.

How much of that, though, is because of the world situation around us? With turmoil in the Middle East, is there a flight of capital? I read stories about how much capital is actually leaving countries like Russia, even the things we have seen in the EU. Are we just really lucky right now? Let us start from Doctor—yes, no?

Mr. EBELING. I think there has been a degree of luck. You might have read in the press like I did that the Russian government is thinking of imposing more export controls on capital leaving the country, precisely because people earn money in the Russian economy from resources and raw materials, etc., and then they also want to park their money outside of Russia. That is very much the case, yes.

Mr. ELY. But I, whether or not it is lucky is a matter of where you sit. If you are a saver, if you are a senior citizen, you are getting killed from an income standpoint by these very low interest rates. And for people in their working years, what is the incentive to save when you go to a bank and maybe it was 75 basis points or a percent on your CDs?

So for the debtor, these low rates are a great idea and a great benefit, but for the creditors, who are as much owed as is owned, they are really taking a beating on this. And it looks like it is going to continue for a while. So again, a matter of whether we are lucky depends so much on where you sit.

Mr. SCHWEIKERT. Understood. When I ask that question, I am actually asking for a series of my concerns of what happens when we start to get real pricing of risk.

Mr. Slaughter?

Mr. SLAUGHTER. You are definitely right that if you look at the fall of 2008, despite the crisis that we are having here in America, demand for Treasuries surged in part because of the fear and uncertainty about some of the other countries at the financial crisis there and what was happening to their sovereign debtors.

And so I think you hit upon an important point, which is our fiscal conversations we need to increasingly see in a global context. It is not just what we do here. There is a limited pool of savings in the global economy, and where those savers choose to allocate what assets they want to buy of U.S. Treasuries relative to other assets in the world, it is not just what we do, it is what other countries are doing.

And to the extent that if they can continue to make progress—the U.K. is having some serious fiscal conversations today and how that plays out, I think, will be very instructive for our country—the more other countries are able to address their fiscal challenges and we aren't, that compounds the problems that we have been talking about today.

Mr. SCHWEIKERT. Okay. And, Mr. Chairman, Dr. Slaughter, my understanding, and you shared with me over the last 12 months, or 11 months as it may be, the Fed has consumed what percentage and how much of U.S. sovereign debt issue?

Mr. SLAUGHTER. Meaning of the United States?

Mr. SCHWEIKERT. Yes.

Mr. SLAUGHTER. One of my fellow panelists may know the numbers better than me, but it is a pretty high fraction of the net new debt that Treasury has issued—has a net been bought by the Fed.

Mr. SCHWEIKERT. Is it close to 80? What percentage of new issuances have been financed through the Fed?

Mr. EBELING. The figure that I found was that just U.S. Treasuries, they have bought about $1.2 trillion.

Mr. SCHWEIKERT. Okay. What percentage of all issuance is that?

Mr. EBELING. The total issuance of debt, let us say, since 2007–2008, has been an additional 3.6—

Mr. SCHWEIKERT. I am just trying to do the QE2 math in my head.

Mr. ELY. Can I interject something here? When you talk about how much the Fed's Treasury holdings have increased, that is only looking at one side of the equation. The other side is, where did the Fed get the funds to buy those Treasuries?

And where they have come from is basically a tremendous increase in the funds, up to now roughly $1.5 trillion, that banks have on deposit in the Fed. So then, arguably, it is the banking industry through the Fed that has financed much of the increase that we have seen in outstanding Federal debt. The Fed is just kind of a middleman.

Mr. SCHWEIKERT. Mr. Chairman, Mr. Slaughter, isn't this sort of right, because in many ways you just closed the circle, because I was going to make the argument that the Fed is a huge, huge buyer of new issuances. They are not as interest rate sensitive, where your banks may say, "Look, I am not going to buy this. I am going to buy an agency product." And is that one of the things that has helped push down these interest rates in the short term of the curve?

Mr. SLAUGHTER. So, again, I had stressed for many, many years, the Fed on its balance sheet, a sizable fraction of its total assets have been Treasury securities at different maturities. That has been in part because of the liquidity and transparency of Treasury markets. They value being able to conduct monetary policy in their open market operation.

So I think the larger challenge for the United States you have hit upon, which is it is the demand from other savers in the United States and, importantly, demand from the rest of the world for U.S. Treasuries that increasingly will shape what happens with interest rates that we have to pay as a country.

Mr. ELY. And if I could add to that, and the reason that will be the case that other foreign countries, foreign investors become more important is because the United States continues to get deeper into debt to the rest of the world. And so as an economy as a whole, we are sucking in more and more of the world's savings.

Just imagine that the United States was not in that debtor position. In effect, we would owe the money to ourselves in terms of the economy as a whole. But we are in hock to the rest of the world, ultimately, because of our low savings rate in this country that has led to this $3 trillion-plus net debtor position that we have.

Mr. EBELING. If I can add just one more point here, there is a bit of a musical chairs situation here. The Fed goes in and buys up all of these Treasury securities and mortgage-backed securities out of bank portfolios. Then they pay these banks an interest rate higher than market rates to park the money that they have created with the Federal Reserve.

It still ends up being money that the Federal Reserve created out of thin air. It may have this appearance on the ledger book, assets and liabilities—

Mr. SCHWEIKERT. It is a three-legged—

Mr. EBELING. It is still funny money.

Mr. SCHWEIKERT. It is a three-legged stool, where there is a premium paid within it, Mr. Slaughter.

And thank you for tolerating my rambling, Mr. Chairman.

Mr. SLAUGHTER. I was just going to echo Mr. Ely's insight. Japan is a good example. Japan's debt outstanding as a share of GDP is now approaching 200 percent. A major reason we have not had an international financial crisis related to the yen is because the large majority of that debt outstanding is held by Japanese households due to their high savings rate.

Mr. SCHWEIKERT. The internal, yes.

My last statement, and I will share this with you, Mr. Chairman, because you and I have had this conversation on the side, is one of my great, great fears is with the Fed intervention in U.S. sovereign debt and some of the other mechanics out there, we have no real pricing for risk.

We are approaching a debt ceiling. We are approaching a lot of these untenable numbers, but yet the old days when we used to look at bond futures and say, "The market is starting to price risk," in many ways the Fed's actions now, it is hard to know what is reality in the market anymore. Thank you, Mr. Chairman.

Chairman PAUL. And I thank the gentleman.

This hearing is now finished. The Chair notes that some members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

[Whereupon, at 11:40 a.m., the hearing was adjourned.]

A P P E N D I X

May 11, 2011

United States House of Representatives
Committee on Financial Services
Subcommittee on Domestic Monetary Policy
Hearing on Monetary Policy and the Debt Ceiling: Examining the Relationship between the Federal Reserve and Government Debt
May 11, 2011

Congressman Ron Paul
Statement for the Record

I am very pleased to hold this hearing today. For far too long, monetary policy and fiscal policy have been viewed as completely separate issues. Congress controls fiscal policy, the Federal Reserve controls monetary policy, and never the twain shall meet.

The truth, however, is that fiscal and monetary policy have always been tightly intertwined. In fact, the Federal Reserve has served as the enabler of bad economic policy for many decades. Without the Fed's relentless expansion of the money supply during both the Greenspan and Bernanke eras, the U.S. Treasury never would have been able to issue the staggering sums of debt that now threaten our economic well being. This Treasury debt is the very lifeblood of deficit spending, permitting one Congress after another to spend far more than the Treasury collects in taxes. It is precisely this unholy alliance between the enabling Fed and a spendthrift Congress that I hope our witnesses will address today.

Until 1971 the United States operated on a gold exchange standard, meaning dollars could be redeemed in gold by foreign governments. The dollar was thought to be "as good as gold" because the U.S. would never renege on its gold exchange commitment. The U.S. had to keep that commitment or risk gold outflows that presumably would keep the government from engaging in loose fiscal and monetary policy.

Unfortunately, the system did not in fact keep government spending in check. The federal government ran large budget deficits throughout the 1960s, with the Federal Reserve duly covering the gap and inflating the money supply. Foreign creditors understood that the dollar was being devalued, and increasingly began to exchange their dollars for gold. Rather than bring monetary and fiscal policies back into balance, however, the federal government under President Nixon defaulted on its obligations by closing the gold window in August of 1971.

Despite this, the United States' position as the world's largest economy and the de facto leader of the Western world enabled the dollar to maintain its position as the world's major reserve currency. We've also enjoyed having OPEC price oil in dollars, creating enduring worldwide demand for our currency. But without any effective structural restraints on Congressional spending or Fed monetary expansion, our unchecked fiat paper money system has led to an explosion of debt over the last 40 years.

Yet foreign governments (especially those that have large trade surpluses with the United States) continue to purchase Treasury debt in order to keep their excess U.S. dollar reserves from losing value to relentless inflation. Because of the dollar's continued status as the world's reserve currency, there is still a highly liquid market for Treasury securities. These Treasury securities are backed by the full faith and credit of the U.S. government, meaning they are backed by the government's power to levy taxes.

Not surprisingly, the increase in U.S. national debt over the past several years and the likelihood of continued trillion-dollar deficits has caused many of our creditors to rethink their position on Treasury debt. China slowly has begun to reduce its holdings, and indicated that its $3 trillion total foreign exchange reserve is excessive. The investment firm PIMCO completely divested itself of Treasuries, and its co-founder Bill Gross publicly warned of a U.S. debt default. If foreign governments and large institutional investors begin to shy away from U.S. Treasuries, the Federal Reserve will face increasing pressure to monetize new Treasury debt issues.

The recent increases in fiscal deficits have been unprecedented. The $1.4 trillion dollar deficit in FY 2009 was almost as large as the previous five years combined, and FY2010's deficit was not much smaller. Half a decade's worth of new debt could not possibly have been absorbed by the financial markets, at least not without a significant increase in interest rates. The Fed, however, absorbed this deficit by inflating the money supply. Since summer of 2008 the Fed's balance sheet has tripled to $2.7 trillion, while the monetary base has tripled to $2.5 trillion.

The fundamental problem is that Congress cannot and will not cut federal spending and balance the budget. When Congress cannot balance the budget, it must cover the shortfall by raising taxes or borrowing money. Because the burden of taxes falls on current voters, while the burden of interest payments on debt falls largely on future voters, borrowing money has always been the politically favored method of funding.

Both the public and most members of Congress do not understand the mechanics of how the Fed and the Treasury Department work together to create new money and new debt. It's a circular process, but one that affects all Americans perhaps even more than the actions of their elected Congress.

In order to borrow money the Treasury department creates new debt securities, which it sells at auction to banks. However, banks generally do not maintain excess liquidity for the purchase of additional assets, but rather loan out funds up to the limit of their reserve requirements.

In order to facilitate the purchase of new Treasury debt, the Federal Reserve creates money out of thin air to purchase old Treasury debt from the dealers in the market. Banks then find themselves holding excess reserves, which they wish to get rid of by purchasing new assets-- in this case newly issued Treasury debt.

These new excess reserves have an expansionary effect on the banking system. Given a reserve requirement of 5% and thus a money multiplier of 20, $1 billion of asset purchases by the Fed can result in $20 billion of new credit creation, as the initial $1 billion is loaned out through the banking system. This entire system is purely inflationary and causes prices to rise and the purchasing power of the dollar to fall.

As price levels increase and the value of the dollar falls, holders of existing dollar-denominated assets see depreciation in the value of their holdings. This makes them both less willing to continue to hold dollar-denominated assets, as well as less willing to purchase more dollar-denominated assets in the future. But the continued operation of the profligate federal government is contingent upon finding purchasers for new Treasury debt.

Given the anxiety of institutional and government investors, the Fed increasingly must act—in effect—as the buyer of last resort for U.S. Treasury debt. Of course the Fed is prohibited from purchasing Treasury debt directly from the Treasury, as this outright monetization would indicate that the nation's fiscal situation is so bad that the Treasury could not find sufficient debt purchasers to fund its fiscal deficit. So while the Fed does not directly purchase Treasury debt, the number of instances in which it has purchased freshly issued debt directly from primary dealers has begun to gain public attention. This is merely a step away from direct monetization.

Direct debt sales to a central bank are always seen as the last resort of a failed regime, as the central bank at that point acts merely as a rubber stamp for the government's fiscal profligacy. History teaches that the next step is severe inflation, if not hyperinflation, with investors and savers completely wiped out. The only reason we have not experienced hyperinflation so far is that the Fed has managed to keep the monetary base increases in check by paying interest on excess reserves held by banks. If these excess reserves begin to be loaned out, however, all bets are off.

We are told that Congress must raise the debt ceiling limit or else the financial markets and the U.S. economy will suffer great harm. In reality, raising the debt ceiling will allow the government to continue its fiscal profligacy. Fed financed deficits will continue; foreign investors will continue to divest their holdings of Treasury securities; the Fed will be forced to monetize new debt issuances, and prices will continue to rise as the standard of living of the average American continues to plummet. If we have learned anything from history, we should know that printing money out of thin air cannot lead to prosperity. It can only lead to penury.

I believe Congress should refuse to raise the debt ceiling. It would be one of the best things that could happen to this country. Congress finally would be forced to address the spending issue once and for all. Outlays would have to be covered by receipts, and Congress would have to get serious about eliminating unconstitutional government departments and programs. It is my hope that this hearing will help to examine the symbiotic relationship between the Federal Reserve's monetary policy and the Treasury's debt issuance, and I look forward to the testimony of our witnesses.

OPENING STATEMENT OF REP. BILL HUIZENGA

HOUSE FINANCIAL SERVICES COMMITTEE

SUBCOMMITTEE ON DOMESTIC MONETARY POLICY AND TECHNOLOGY

"MONETARY POLICY AND THE DEBT CEILING: EXAMINING THE RELATIONSHIP BETWEEN THE FEDERAL RESERVE AND GOVERNMENT DEBT"

MAY 11, 2011

Good morning and thank you Chairman Paul and Ranking Member Clay for holding this important hearing today.

My constituents in West Michigan continue to make it clear. One of the most vital issues facing this Congress is reigning in spending and reducing our massive debt, and I thank you Chairman Paul for demonstrating that it is a priority by holding this hearing.

The Federal Reserve Board of Governors is congressionally mandated to enact monetary policy with the goal of maximizing employment as well as minimizing inflation. However, after witnessing the load of debt accumulated by the Obama administration's recent attempts to reach such goals through failed *fiscal* policies, I am pleased that we are now spending some time exploring the role of *monetary* policy and the national debt.

In recent years, the FED has taken unprecedented action to provide liquidity to the financial markets through the purchase of government debt. Most recently, due to the fact that the federal funds rate sits near zero percent, the FED decided to purchase an additional $600 billion of Treasury securities commonly referred to as "quantitative easing" or "QE2." This strategy was undertaken despite the fact that the first round of quantitative easing (QE1) – the FED purchase of $1.2 trillion in Treasury and Agency securities in March 2009 – has not proven to be an effective method of creating jobs.

Today we will examine what affect the federal government's debt plays in the Federal Reserve's open market operations. In addition, I look forward to inspecting how that role affects our yearly deficits when compared to the more costly tax and spend fiscal policies.

As a Member of the 112th Congress and a member of this important subcommittee charged with overseeing operations at the Federal Reserve, I take my responsibility for strict oversight of taxpayer dollars with the utmost seriousness. I look forward to today's robust discussion on the relationship between monetary policy and the debt, as well as the potentially negative long-term consequences from the FED's most recent unparalleled intervention in the markets.

Mr. Chairman, thank you again for holding this important hearing, and I look forward to hearing from our witnesses.

Testimony for the Subcommittee on Domestic Monetary Policy and Technology, on "Monetary Policy and the Debt Ceiling: Examining the Relationship between the Federal Reserve and Government Debt," Wednesday, May 11, 2011

Monetary Policy, the Federal Reserve, and the National Debt

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Government Debt and Deficits

The current economic crisis through which the United States is passing has given a heightened awareness to the country's national debt. After a declining trend in the 1990s, the national debt has dramatically increased from $5.7 trillion in January 2001 to $10.7 trillion at the end of 2008, to over $14.3 trillion through April of 2011. The debt has reached 98 percent of 2010 U.S. Gross Domestic Product.

The approximately $3.6 trillion that has been added to the national debt since the end of 2008 is more than double the market value of all private sector manufacturing in 2009 ($1.56 trillion), more than three times the market value of spending on professional, scientific, and technical services in 2009 ($1.07 trillion), and nearly five times the amount spent on nondurable goods in 2009 ($722 billion). Just the interest paid on the government's debt over the first six months of the current fiscal (October 2010-April 2011), nearly $245 billion, is equal to more than 40 percent of the total market value of all private sector construction spending in 2009 ($578 billion)[i]

This highlights the social cost of deficit spending, and the resulting addition to the national debt. Every dollar borrowed by the United States government, and the real resources that dollar represents in the market place, is a dollar of real resources not available for use in private sector investment, capital formation, consumer spending, and therefore increases and improvements in the quality and standard of living of the American people.

In this sense, the government's deficit spending that cumulatively has been increasing the national debt has made the United States that much poorer than it otherwise could have and would have been, if the dollar value of these real resources had not been siphoned off and out of use in the productive private sectors of the American economy.

What has made this less visible and less obvious to the American citizenry is precisely because it has been financed through government borrowing rather than government taxation. Deficit spending easily creates the illusion that something can be had for nothing. The government borrows "today" and can provide "benefits" to various groups in the society in the present with the appearance of no immediate "cost" or "burden" upon the citizenry.

Yet, whether acquired by taxing or borrowing, the resulting total government expenditures represent the real resources and the private sector consumption or investment spending those resources could have financed that must be foregone. There are no "free lunches," as it has often been pointed out, and that applies to both what government borrows as much as what it more directly taxes to cover its outlays.

What makes deficit spending an attractive "path of least resistance" in the political process is precisely the fact that it enables deferring the decision of telling voter constituents by how much taxes would otherwise have to be increased, and upon whom they would fall, in the "here and now" to generate the additional revenue to pay for the spending that is financed through borrowing.[ii]

But as the recent fiscal problems in a number of member nations of the European Union have highlighted, eventually there are limits to how far a government can try to hide or defer the real costs of all that it is providing or promising through its total expenditures to various voter constituent groups. Standard & Poor's recent decision to downgrade the U.S. government's prospective credit rating to "negative" shows clearly that what is happening in parts of Europe *can happen here.*

And given current projections by the Congressional Budget Office, the deficits are projected to continue indefinitely into future years and decade, with the cumulative national debt nearly doubling from its present level.[iii] In addition, whether covered by taxes or deficit financing, these debt estimates do not include the federal government's unfunded liabilities for Social Security and Medicare through most of the 21st century. In 2009, the Social Security and Medicare trust funds were estimated to have legal commitments under existing law for expenditures equal to at least $43 trillion over the next seventy-five years.[iv] Others have projected this unfunded liability of the United States government to be much higher – possibly over $100 trillion.[v]

The Federal Reserve and the Economic Crisis

The responsibility for a good part of the current economic crisis must be put at the doorstep of America's central bank, the Federal Reserve. By some measures of the money supply, the monetary aggregates (MZM or M-2) grew by fifty percent or more between 2003 and 2007. This massive flooding of the financial markets with huge amounts of liquidity provided the funds that fed the mortgage, investment, and consumer debt bubbles in the first decade of this century. Interest rates were pushed far below any historical levels.

For a good part of those five years, according to the St. Louis Federal Reserve Bank, the federal funds rate (the rate of interest at which banks lend to each other), when adjusted for inflation – the "real rate" – was either negative or well below two percent. In other words, the Federal Reserve supplied so much money to the banking sector that banks were lending money to each other for free for a good part of this time. It is no wonder that related market interest rates were also pushed way down during this period.[vi]

Market interest rates are supposed to tell the truth. Like any other price on the market, interest rates are suppose to balance the decision of income earners to save a portion of their income with the desire of others to borrow that savings for various investment and other purposes. In addition, the rates of interest, through the present value factor, are meant to limit investment time horizons undertaken within the available savings to successfully bring the investments to completion and sustainability in the longer-term.

Due to the Fed's policy, interest rates were not allowed to do their "job" in the market place. Indeed, Fed policy made interest rates tell "lies." The Federal Reserve's "easy money" policy made it appear, in terms of the cost of borrowing, that there was more than enough real resources in the economy for spending and borrowing to meet everyone's consumer, investment and government deficit needs far in excess of the economy's actual productive capacity.[vii]

The housing bubble was indicative of this. To attract people to take out loans, banks not only lowered interest rates (and therefore the cost of borrowing), they also lowered their standards for credit worthiness. To get the money, somehow, out the door, financial institutions found "creative" ways to bundle together mortgage loans into tradable packages that they could then pass on to other investors. It seemed to minimize the risk from issuing all those sub-prime home loans, which we now see were really the housing market's version of high-risk junk bonds. The fears were soothed by the fact that housing prices kept climbing as home buyers pushed them higher and higher with all of that newly created Federal Reserve money.

At the same time, government-created home-insurance agencies like Fannie Mae and Freddie Mac were guaranteeing a growing number of these wobbly mortgages, with the assurance that the "full faith and credit" of Uncle Same stood behind them. By the time the Federal government formally had to take over complete control of Fannie and Freddie in 2008, they were holding the guarantees for half of the $10 trillion American housing market.[viii]

Low interest rates and reduced credit standards were also feeding a huge consumer-spending boom that resulted in a 25 percent increase in consumer debt between 2003 and 2008, from $2 trillion to over $2.5 trillion. With interest rates so low, there was little incentive to save for tomorrow and big incentives to borrow and consume today. But, according to the U.S. Census Bureau, during this five-year period average real income only increased by at the most 2 percent. Peoples' debt burdens, therefore, rose dramatically.[ix]

The easy money and government-guaranteed house of cards all started to come tumbling down in the second half of 2008. The Federal Reserve's response was to open wide the monetary spigots even more than before the bubbles burst.

The Federal Reserve has dramatically increased its balance sheet by expanding its holding of U.S. government securities and private-sector mortgage-back securities to the tune of around $2.3 trillion. Traditional Open Market Operations plus its aggressive "quantitative easing" policy have increased bank reserves from $94.1 billion in 2007 to $1.3 trillion by April 2011, for a near fourteen-fold increase, and the monetary basis in general has expanded from $850.5 billion in 2007 to $2,242.9 trillion in April of 2011, for a 260 percent increase. The monetary aggregates, MZM and M-2, respectively, have grown by 28 percent and 21.6 percent over this same period.[x]

In the name of supposedly preventing a possible price deflation in the aftermath of the economic boom, Fed policy has delayed and retarded the economy from effectively readjusting and re-coordinating the sectoral imbalances and distortions that had been generated during the bubble years.[xi] Once again interest rates have been kept artificially low. In real terms, the federal funds rate and the 1-year Treasury yield have been in the negative range since the last quarter of 2009, and at the current time is estimated to be below *minus* two percent.

This has prevented interest rates from informing market transactors what the real savings conditions are in the economy. So, once again, the availability of savings and the real cost of borrowing is difficult to discern so as to make reasonable and rational investment decisions, and not to foster a new wave of misdirected and unsustainable private sector investment and financial decisions.

The housing market has not been allowed to fully adjust, either. With so much of the mortgage-backed securities being held off the market in the portfolio of the Federal Reserve, there is little way to determine any real market-based pricing to determine their worth or their total availability so the housing market can finally bottom out with clearer information of supply and demand conditions for a sustainable recovery.

This misguided Fed policy has been, in my view, a primary factor behind the slow and sluggish recovery of the United States economy out of the current recession.

Federal Reserve Policy and Monetizing the Debt
Many times in history, governments have used their power over the monetary printing press to create the funds needed to cover their expenses in excess of taxes collected. Sometimes this has lead to social and economic catastrophes.[xii]

Monetizing the debt refers to the creation of new money to finance all or a portion of the government's borrowing. Since the early 2008 to the present, Federal Reserve holdings of U.S. Treasuries have increased by about 240 percent, from $591 billion in March 2008 to $1.4 trillion in early May 2011, or a nearly $1 trillion increase. In the face of an additional $3.6 trillion in accumulated debt during the last three fiscal years, it might seem that Fed policy has "monetized" less than one-third of government borrowing during this period.

However, the Fed's purchase of mortgage-backed securities, no less than its purchase of U.S. Treasuries, potentially increases the amount of reserves in the banking system available for lending. And since 2008, the Federal Reserve had bought an amount of mortgaged-backed securities that it prices on its balance sheet as being equal about $928 billion.

The $1.4 trillion increase in the monetary base since the end of 2007, from $850.5 billion to $2.2 trillion, has increased MZM measurement of the money supply by $2,161.1, or an additional $769 billion dollars in the economy above the increase in the monetary base. This is an amount that is 83 percent of the dollar value of the $927 billions in mortgage-backed securities.

Due to the "money multiplier" effect – that under fractional reserves, total new bank loans are potentially a multiple of the additional reserves injected into the banking system – it is not necessary for the Fed to purchase, dollar-for-dollar, every additional dollar of government borrowing to generate a total increase in the money supply that may be equal to the government's deficit.

Thus, it can be argued that Fed monetary policy has succeeded, in fact, in generating an increase in the amount of money in the banking system that is equal to two-thirds of the government's $3.6 trillion of new accumulated debt.

That the money multiplier effect has not been as great as it might have been, so far, is because the Federal Reserve has been paying interest to member banks to *not lend* their excess reserves. This sluggishness in potential lending has also been affected by the general "regime uncertainty" that continues to pervade the economy. This uncertainty concerns the future direction of government monetary and fiscal policy. In an economic climate in which it difficult to anticipate the future tax structure, the likely magnitude of future government borrowing, and the impact of new government programs, hesitancy exists on the part of both borrowers and lenders to take on new commitments.

But the monetary expansion has most certainly has been the factor behind the worsening problem of rising prices in the U.S. economy and the significant fall in the value of the dollar on the foreign exchange markets.

The National Debt and Monetary Policy

It is hard for Americans to think of their own country experiencing the same type of fiscal crisis that has periodically occurred in "third world" countries. That type of government financial mismanagement is supposed to only happen in what used to be called "banana republics."

But the fact is, the U.S. is following a course of fiscal irresponsibility that may lead to highly undesirable consequences. The bottom line truth is that over the decades the government – under both Republican and Democratic leadership – has promised the American people, through a wide range of redistributive and transfer programs and other on-going budgetary commitments, more than the U.S. economy can successfully deliver without seriously damaging the country's capacity to produce and grow through the rest of this century.

To try to continue to borrow our way out of this dilemma would be just more of the same on the road to ruin. The real resources to pay for all the governmental largess that has been promised would have to come out of either significantly higher taxes or crowding out more and more private sector access to investment funds to cover continuing budget deficits. Whether from domestic or foreign lenders, the cost of borrowing will eventually and inescapably rise. There is only so much savings in the world to fund private investment and government borrowing, particularly in a world in which developing countries are intensely trying to catch up with the industrialized nations.

Interest rates on government borrowing will rise, both because of the scarcity of the savings to go around and lenders' concerns about America's ability to tax enough in the future to pay back what has been borrowed. Default risk premiums need not only apply to countries like Greece.

Reliance on the Federal Reserve to "print our way" out of the dilemma through more monetary expansion is not and cannot be an answer, either. Printing paper money or creating it on computer screens at the Federal Reserve does not produce real resources. It does not increase the supply of labor or capital – the machines, tools, and equipment – out of which desired goods and services can be manufactured and provided. That only comes from work, savings and investment. Not from more green pieces of paper with presidents' faces on them.

However, what inflation can do is:

- Accelerate the *devaluation of the dollar* on the foreign exchange markets, and thereby disrupting trading patterns and investment flows between the U.S. and the rest of the world;
- *Reduce the value, or purchasing power, of every dollar* in people's pockets throughout the economy as prices start to rise higher and higher;
- *Undermine the effectiveness of the price system* to assist people as consumers and producers in making rational market decisions, due to the uneven manner in which inflation impacts of some prices first and effects others only later;
- *Potentially slow down capital formation or even generate capital consumption*, as inflation's uneven effects on prices makes it difficult to calculate profit from loss;
- *Distort interest rates in financial markets, creating an imbalance between savings and investment that sets in motion the boom and bust of the business cycle;*
- *Create incentives for people to waste their time and resources trying to find ways to hedge against inflation*, rather than devote their efforts in more productive ways that improve standards of living over time;
- *Bring about social tensions as people look for scapegoats to blame for the disruptive and damaging effects of inflation*, rather than see its source in Federal Reserve monetary policy;
- Run the risk of *political pressures to introduce distorting price and wage controls or foreign exchange regulations* to fight the symptom of rising prices, rather than the source of the problem – monetary expansion.

What is To Be Done?

The bottom line is, government is too big. It spends too much, taxes too heavily, and borrows too much. For a long time, the country has been trending more and more in the direction of increasing political paternalism. Some people argue, when it is proposed to reduce the size and scope of government in our society, that this is breaking some supposed "social contract" between government and "the people."

The only workable "social contract" for a free society is the one outlined by the American Founding Fathers in the Declaration of Independence and formalized in the Constitution of the United States. This is a social contract that recognizes that all men are created equal, with governmental privileges and favors for none, and which expects government to respect and secure each individual's right to his life, liberty, and honestly acquired property.

The reform agenda for deficit and debt reduction, therefore, must start from that premise and have as its target a radical "downsizing" of government. That policy should plan to reduce government spending across the board in every line item of the federal budget by 10 to 15 percent each year until government has been reduced in size and scope to a level and a degree that resembles, once again, the Founding Father's conception of a free and limited government.[xiii]

A first step in this fiscal reform is to *not* increase the national debt limit. The government should begin, *now*, living within its means – that is, the taxes currently collected by the Treasury. In spite of some of the rhetoric in the media, the U.S. need not run the risk of defaulting or losing its international financial credit rating. Any and all interest payments or maturing debt can be paid for out of tax receipts. What will have to be reduced are other expenditures of the government.

But the required reductions and cuts in various existing programs should be considered as the necessary "wake-up call" for everyone in America that we have been living far beyond our means. And as we begin living within those means, priorities will have to be made and trade-offs will have to be accepted as part of the transition to a smaller and more constitutionally limited government.

In addition, the power of monetary discretion must be taken out of the hands of the Federal Reserve. The fact is, central banking is a form of monetary central planning under which it is left in the hands of the members of the Board of Governors of the Federal Reserve to "plan" the quantity of money in the economy, influence the value or purchasing power of the monetary unit, and manipulate interest rates in the loan markets.

The monetary central planners who run the Federal Reserve have no more or greater knowledge, wisdom or ability that those central planners in the old Soviet Union. The periodic recurrence of the boom and bust of the business cycle demonstrates that there is no way for them to get it right – in spite of them saying, again and again, that "next time" they will get it right.

It is what the Nobel Prize-winning, Austrian economist, Friedrich A. Hayek, once called a highly misplaced "pretense of knowledge." That is why in a wide agenda for reform, the goal should be to move towards a market-based monetary system, the first step in such an institutional change being a commodity-backed monetary order such as a gold standard.[xiv]

And in the longer-run serious consideration must be given the possibilities of a monetary system completely privatized and competitive, without government control, management, or supervision.[xv]

The budgetary and fiscal crisis right now has made many political issues far clearer in people's minds. The debt dilemma is a challenge and an opportunity to set America on a freer and potentially more prosperous track, if the reality of the situation is looked at foursquare in the eye.

Otherwise, dangerous, destabilizing, and damaging monetary and fiscal times may be ahead.

End Notes

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xii See, Richard M. Ebeling, "The Lasting Legacies of World War I: Big Government, Paper Money, and Inflation," *Economic Education Bulletin*, Vol. XLVIII, No. 11 (Great Barrington, MA: American Institute for Economic Research, November 2008), for a detailed example of the German and Austrian instances of monetary-financed inflationary destruction following the First World War.

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Testimony by Bert Ely
to the
Subcommittee on Domestic Monetary Policy and Technology
of the
House Committee on Financial Services
at a hearing titled
Monetary Policy and the Debt Ceiling: Examining the Relationship between the Federal Reserve and Government Debt
May 11, 2011

Mr. Chairman Paul, Ranking Member Clay, and members of the Subcommittee, I very much appreciate the opportunity to testify to you today about the relationship between the Federal Reserve and government debt, specifically as that relationship relates to monetary policy and the federal debt ceiling. After first discussing the Fed's balance sheet and financial results in recent years, I will address policy questions related to the relationship of the Fed to the Treasury Department and the wisdom of monetary policy.

The Federal Reserve's balance sheet

I begin by presenting two charts (attached) which illustrate the components of the Fed's balance sheet over the last four years – Exhibit 1 shows the components of the asset side of the Fed's balance sheet and Exhibit 2 shows the components of the liability side of its balance sheet.[1] These two charts show the extremely rapid growth of the Fed balance sheet – it more than doubled in size, with from total assets rising from $907 billion on September 3, 2008, to $2.26 trillion on December 17, 2008. After shrinking in early 2009, the Fed balance sheet resumed growing, reaching an all-time high of $2.72 trillion just last Wednesday, May 4, 2011. How much more it will grow is anyone's guess.

As the Fed balance sheet has grown, the composition of its assets has changed significantly. In 2008 and through 2009, most the growth in the Fed's assets was related to the Fed's support of the financial system through programs such as its Term Auction Credit, loans to banks and others, such as AIG, and portfolio investments, principally three Maiden Lane LLCs. The Fed also engaged in liquidity swaps with other central banks to help ease international monetary pressures. To finance these new activities, the Fed first shrank its holdings of Treasury securities – they declined from a peak of $791 billion on August 8, 2007, to a low of $475 to $480 billion between June of 2008 and March of 2009.

About two years ago, Fed assets began a second transformation which continues to this day. While its balance sheet has continued to grow, Fed lending to and investments in the credit markets and private-sector institutions has declined significantly while all of its central bank liquidity swaps

[1] The data presented in these two charts are taken from Table 9 in the Federal Reserve's weekly H.4.1 statistical release. That table presents the statement of condition (balance sheet), as of the Wednesday of that week, for each of the twelve Federal Reserve banks and a consolidated balance sheet for all twelve banks.

have expired, reflecting the increased stability of the international financial markets. At the same time, the Fed's investment in federal agency debt, i.e., debt issued by government-sponsored enterprises (GSEs), and mortgage-backed securities (MBS)[2] has grown dramatically – from an initial $10 billion on September 24, 2008, to $1.05 trillion last Wednesday; that amount is down from a peak of $1.294 trillion on June 23, 2010. The Fed now owns about 14% of the total debt and MBS issued or guaranteed by the three housing-finance GSEs and Ginnie Mae.

The other element of the second transformation in the Fed's asset composition has been the growth of its holdings of Treasury securities. From March 2009 to October 2009, they rose to a new plateau, in the range of $775 billion, which held until August 2010. Since then, the Fed's holdings of Treasury securities have nearly doubled, to $1.442 trillion as of last Wednesday. This tremendous growth in the Fed's Treasury securities reflects in large part the consequence of the Fed's Quantitative Easing program to bring down longer term interest rates.

As Exhibit 2 shows, almost all of the growth in the Fed's liabilities has occurred in its deposits – from the Treasury Department and from banks. Treasury deposits started rising in late September 2008 and peaked at $615 billion on October 22, 2008, as the Treasury borrowed funds to effective lend to the Fed so that the Fed could lend and invest those funds in the financial markets.

As the proceeds from the Fed's lending and investing began flowing into banks, banks deposited those funds in the Fed. On October 9, 2008, the Fed began paying interest on reserve balances, which gave banks an incentive to hold cash balances at the Fed. Consequently, as Exhibit 2 shows, bank deposits at the Fed grew dramatically in late 2008 and early 2009, rising from $11 billion on September 3, 2008, to $860 billion on December 31, 2008.

The jump in bank deposits permitted the Treasury to begin to reduce its deposits at the Fed, a trend that, with ups and downs, has continued to this day. That reduction in its deposits at the Fed has permitted a corresponding reduction in Treasury borrowings. After remaining relatively flat through 2010, bank deposits at the Fed began rising during the first quarter of this year, reaching $1.54 trillion on April 13, 2011. Bank deposits at the Fed now account for more than 10% of total banking-industry assets.

Exhibit 2 also illustrates the relatively steady growth of the Fed's other major liability – currency outstanding. Over the last four years, from May 2, 2007, to May 4, 2011, currency outstanding (much of which circulates outside the United States) has grown at a compound annual rate of 6.02%.[3] Currency (along with coins issued by the Treasury) represents the non-interest-bearing portion of the federal debt. Although pieces of currency are labeled as Federal Reserve Notes, they are in fact just as much a liability of the federal government as are the interest-bearing bills, notes, and bonds issued by the Treasury Department. That is, each piece of currency represents a zero-interest Treasury bill with no fixed maturity date.

Currency outstanding, i.e., currency actually in circulation versus currency sitting in Fed vaults, is the one element of the Fed balance sheet over which the Fed has no control as to the amount outstanding. That is, the amount of currency outstanding is totally demand-driven. The Fed

[2] Fannie Mae and Freddie Mac debt and MBS, Federal Home Loan Bank System debt, and Ginnie Mae MBS.

[3] The annual growth rates within that four-year period (measured from the Wednesday closest to May 2) were as follows: .64%, 11.42%, 3.65%, and 8.71%.

cannot force currency into circulation – Americans and others will hold only as much currency as they desire, and no more. That is why the Fed could not look to currency as a funding source for its tremendous balance-sheet growth in recent years. Instead, the Fed has had to borrow from the Treasury, in the form of Treasury deposits, and from the banking industry, in the form of deposits banks have placed at the Fed. If inflation emerges again in the United States, it will not be because the government literally cranked up the printing press to force more paper currency into circulation.

Exhibit 3 illustrates the symbiotic relationship between the Fed and the Treasury by showing the extent to which the Net Treasury Position (NTP) at the Fed has varied over the last four years. The NTP is merely the total amount of Treasury securities owned by the Fed at any point in time minus the amount the Treasury has on deposit at the Fed on that day. In effect, the NTP measures the extent to which the Fed is using liabilities largely held in the private sector – currency and bank deposits at the Fed – to finance the federal government's accumulated deficit.

Normally, the NTP is positive because the Fed invests the proceeds of its currency issuance in Treasury securities. However, in late 2007, as the Fed began to support the private credit markets and global financial stability, the NTP started to decline before falling off the cliff in the fall of 2008. From December 5, 2007, to October 22, 2008, the NTP dropped $913 billion, reaching a negative position of $138 billion on the latter date. The Treasury had to access the capital markets to fund that drop in the NTP. Fortunately, rates on Treasury debt remained relatively stable during that time. It then took over two years, until January 12 of this year, for the NTP to reach its former level. Since then, the NTP has grown another $524 billion as bank deposits at the Fed have grown and as the Fed has steadily liquidated its non-traditional loans and investments.

Exhibit 4 further illustrates changes in the Fed balance sheet over the last four years. The left column (June 6, 2007) illustrates a typical pre-crisis Fed balance sheet, with Fed-issued currency intermediated into Treasury securities and both of those items comprising approximately 90% of their side of the Fed balance sheet.

The middle column (June 3, 2009) shows the Fed just past the peak of the credit-market crisis but as it is ramping up its support of the housing-finance GSEs. The bracketed numbers, totaling $1.213 trillion, show the amount of non-traditional support the Fed was providing to the credit markets and the GSEs at that time.

The right column summarizes the most recently available Fed balance sheet – May 3, 2011. Although almost $650 billion larger than the June 3, 2009, balance sheet, it shows a substantial increase – $836 billion – in Treasury securities as the NTP was rebuilt but only a modest $80 billion decline in non-traditional credit support. However, all but $81 billion of that non-traditional activity represented Fed support of the housing GSEs – over $1 trillion.

The Fed has become an extremely profitable bank

There has been insufficient recognition that the Fed has become an extremely profitable bank since 2007. Exhibit 5 illustrates the Fed income statement for 2007 – the last "normal" Fed year in which it sent back to the Treasury $5.7 billion less than it received as interest on Treasury securities. That is, Fed activities cost taxpayers $5.7 billion for calendar year 2007.

Exhibit 6, which illustrates the Fed income statement for 2010, shows how the Fed earned a $52.9 billion profit for taxpayers last year as it assumed substantial credit and market risks. That is, the Fed returned $52.9 billion more to the Treasury than the Treasury paid the Fed as interest on its Treasury securities – $79.27 billion paid to the Treasury by the Fed minus $26.37 billion paid to the Fed by the Treasury.

Exhibit 7 shows changes in the Fed's income statement from 2007 to 2010. Three items are of particular note in this exhibit. First, the decline in the amount of interest the Fed earned on its Treasury securities reflects the decline of the average yield on the Fed's Treasury securities offset to a small degree by a 3.3% increase in the average amount of the Fed's Treasury securities in 2010 relative to 2007. Second, the tremendous increase – from $575 million in 2007 to $53.02 billion in 2010 – in interest the Fed earned other than on loans and its Treasury securities. Third, largely as a result of that jump in "other interest income," the huge increase in the monies the Fed returned to the Treasury.

The Fed's 2010 profitability follows Fed profits of $24.5 billion in 2009 and $4.2 billion in 2008.[4] Over 2008 to 2010 period, the Fed increased its Surplus account (in effect, Fed earnings not turned over to the Treasury) by $8.07 billion. Therefore, over 2008-2010 period, the Fed earned almost $90 billion – $89.681 billion to be exact. By contrast, the total after-tax profit for the 2008-2010 period for all FDIC-insured institutions was less, $81.39 billion.

The Fed's profitability in recent years has been due to, one, the tremendous growth in its income-producing assets, specifically GSE debt and MBS; two, its extremely low cost of funds – zero on the currency it issues and .25% on deposits banks have placed with it; and three, the relatively modest increase in its operating expenses since 2007. Given that all three trends have continued into 2011, there is every reason to believe that 2011 will be another extremely profitable year for the Fed. A key public-policy question, though, is whether the federal government, through the Fed, should play such a substantial role in the credit-intermediation business.

The Fed should be viewed as an extension of the U.S. Treasury

Although Congress chartered the Fed as an independent entity, specifically to operate independently of the Executive Branch, that independence should be questioned from two perspectives – the management of the federal government's finances and the efficacy and desirability of monetary policy. This section of my testimony will examine Fed independence from a financial perspective while the next section will address monetary policy.

Federal Reserve independence is a myth in one crucial regard – it is a creature of Congress and it operates with the full-faith-and-credit backing of the federal government and therefore of the federal taxpayer. The Fed has no creditworthiness of its own – its creditworthiness stems strictly from being an instrumentality of the federal government and therefore from the financial backing of American taxpayers. In this regard, the Fed is no different than all other central banks. The Fed has independent decision-making power only to the extent that Congress has granted that power.

[4] For 2009, the Fed earned $22.89 billion on its Treasury securities and returned $47.43 billion to the Treasury. For 2008, the Fed earned $27.52 billion on its Treasury securities and returned $31.69 billion to the Treasury.

Likewise, the Fed's ability to issue currency, and to earn interest on investments funded by that currency, was authorized by Congress, and could be retracted by Congress.

Key to understanding the linkage of the Fed to the rest of the federal government is to consolidate the Fed and Treasury Department balance sheets. Exhibit 8 places these two balance sheets side-by-side. Exhibit 9 presents an accounting consolidation of the two balance sheets so as to present a more complete picture of the federal government'2s finances.[5]

There are important merits in viewing the Treasury and Fed balance sheets on a consolidated basis. First, the asset side of this balance sheet shows the extent to which the federal government – through the Treasury and the Fed – is supplying credit to the private sector, notably to finance housing and higher education. That amount of credit as well as other assets financed by the Fed and the Treasury totaled to $2.12 trillion at the end of March 2011, as shown in Exhibit 10. This government-supplied credit has been funded entirely by Treasury debt, pushing the outstanding federal debt $2.12 trillion closer to the federal debt ceiling.[6]

Second, the liability side of this consolidated balance shows in Exhibit 10 that private-sector funds – principally deposits by banks in the Fed – provided $1.676 billion of financing to the federal government as of the end of March 2011. These non-Treasury-debt liabilities effectively funded 79% of the federal government's financial assets at March 31 ($1.676 trillion/$2.12 trillion). One of the big financial challenges the federal government (i.e. the Fed and the Treasury) faces going forward is winding down both of these components of the government's balance sheet as the economy continues to recover.

Third, the liability side of the consolidated balance sheet shows that at the end of March currency outstanding accounted for 10.4% of the total federal debt held by the public – $964 billion in currency plus $8.313 trillion of interest-bearing Treasury debt. The non-interest-bearing portion of the total debt held by the public has declined in recent years as budget deficits have forced the issuance of substantial amounts of interest-bearing debt. At the end of 2007, currency accounted 15.3% of the federal debt held by the public.[7]

Given the magnitude of federal budget deficits for the foreseeable future, the currency portion of the federal debt will continue to decline unless the federal government adopts the practice of third-world countries and, one, begins to pay its bills in currency and, two, refuses to permit banks to exchange currency deposited with them for interest-bearing Treasury debt. Given the

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[5] The Treasury balance sheet is derived from Table 6 of the Monthly Treasury Statement; the most recent statement is as of March 31, 2011. The nearest Federal Reserve balance sheet is as of March 30, 2011. The difference in Treasury deposits at the Fed is due to the effect of March 31, 2011, transactions on the Treasury cash balance at the Fed. Other transactions on March 31, 2011, would affect the amounts shown in Exhibit 9, but the effect of those transactions is not considered to be material for the purposes of this discussion.

[6] For the purpose of calculating the amount of federal debt subject to the federal debt ceiling, outstanding federal debt includes debt held by the public and the Federal Reserve as well as intragovernmental holdings of Treasury debt securities (such as Treasuries held by the Social Security Trust Fund), but excludes currency outstanding.

[7] At December 31, 2007, Treasury debt held by the public and the Fed was $5.122 trillion, including $741 billion held by the Fed. Currency outstanding on that date was $792 billion. Therefore, the total federal debt held by the public was $5.173 trillion ($5.122 trillion - $741 billion + $792 billion); $792 billion/$5.173 trillion = 15.3%.

evolution of the federal government's payment mechanisms from currency[8] to checks to direct deposit, it is highly unlikely that the federal government can finance future deficits with currency, except to the extent that Americans and non-Americans are willing to hold U.S. currency. <u>The printing press will not be a cure for financing future deficits</u>.

In sum, the Fed could be folded into the Treasury Department tomorrow with no adverse effects (except for the jobs that would be eliminated and the Fed buildings which could be sold). Doing so would permit a unified management of the federal government's balance sheet and the Treasury Department could directly issue currency, as it did in pre-Fed days. Because of current payment technology, there would be no danger, as a practical matter, of Treasury over-issuance of U.S. currency. To further protect against over-issuance, Congress could provide a statutory guarantee of the convertibility of U.S. currency into interest-bearing Treasury debt.

The Treasury also could assume the role of lender-of-last-resort. Since the Fed, when acting as an emergency lender, is lending taxpayer dollars and using its federal backing to support any guarantees it issues, it is not doing anything that the Treasury itself could not do. Put another way, the Fed has no resources or powers at its disposal that the Treasury Department does not also have or could have, if Congress so provided. Treasury's assumption of the lender-of-last-resort role also would bring much great political accountability to such lending. The need for greater accountability was quite evident during the recent crisis.

Since folding the Fed into the Treasury is unlikely to occur in the near future, Congress could take the next best step and mandate that the Treasury Department periodically produce, say monthly, a consolidated balance sheet of the Fed and the Treasury, as I present in Exhibits 9 and 10. Such a consolidation would present a much more complete picture of federal finances and the impact of the federal government on the U.S. economy.

Does America benefit from monetary policy?

The fundamental premise of central-bank independence is that monetary policy must be free of political interference. Leaving aside the merits of that premise, the key question is: What constitutes monetary policy?

As a practical matter, monetary policy today consists solely of the Fed trying to influence interest rates through its open-market operations. That activity consists of the New York Fed, as agent for the Federal Reserve System, buying and selling Treasury securities or engaging in repurchase transactions involving Treasuries. The purpose of these transactions is hold the overnight Fed Funds rate as close as practical to the Federal Funds Rate Target (FFRT)[9] set by the Fed's Federal Open Market Committee, or FOMC.[10] The Fed also has used open market operations to carry out its Quantitative Easing initiatives and to accumulate its inventory of GSE debt and MBS.

[8] In 1966, this witness was paid in currency while he was on active duty for training in the U.S. Army. Presumably no federal employee is paid in currency today.
[9] The FFRT is the interest rate the Fed would like to see in the overnight Fed Funds market; i.e., the interest rate at which banks lend to each other on an overnight basis. The FFRT is viewed as the "anchor" for longer-term interest rates.
[10] The FOMC has twelve members – the seven Fed governors, the president of the New York Fed, and four of the presidents of the other eleven Fed banks, who serve on a rotating basis as voting members of the FOMC.

Fed management of the money supply has no relevance today, from a monetary-policy perspective, because, one, the amount of currency in circulation is totally demand-driven and two, money (however defined) is merely that portion of the credit supply which also can efficiently serve as media of exchange. Inflation in a modern industrial economy – whether of assets or consumption goods – is to a great extent a function of the price of credit. If credit is underpriced – interest rates are too low – inflation may begin to emerge as increased demand stimulated by underpriced credit causes the economy to overheat and asset prices to soar, as we saw in the recent U.S. housing bubble. Overpriced credit – interest rates are too high – has the opposite effect. Demand for goods, services, and assets declines, increasing the potential for an economic downturn and price deflation.

Given that monetary policy is all about interest rates, the question is who can better set interest rates – a committee of government bureaucrats (which the FOMC is) or the financial markets? The experience of recent years certainly does not support the notion that bureaucrats can do a better job than the financial markets in determining the price of credit. This question can be posed another way – what is it about credit that makes it desirable for government to determine its price, or at least to try to do that, when it is well known that government price-fixing of other services is highly undesirable?

Some argue that a central bank must provide a "nominal anchor" for the credit markets – a pricing benchmark, if you will. In the United States, that would be the FFRT. Quite possibly, the interest rate the Fed now pays on the reserves (i.e., deposits banks have placed at the Fed), will emerge as another component of the Fed's interest-rate price-fixing activity..

In the opinion of this witness, a strong case has never been made that the financial markets cannot set interest rates across the entire yield curve that will promote stable, non-inflationary economic growth while minimizing the emergence of asset bubbles.[11] More specifically, there certainly is no reason why the interbank lending market cannot establish and vary the overnight interest rate which the FOMC now establishes through its open-market operations.

I encourage this subcommittee to address the question of why interest rates need a "nominal anchor," why it is in the public interest to have a government committee signaling what its members consider to be the appropriate level of interest rates, and why the Fed should try to enforce that signal through open-market operations? If the case cannot be made that the Fed's interest-rate signaling is beneficial to the U.S. economy, then the primary *raison d'être* for the Fed disappears, which would open the door to folding the Fed into the Treasury Department.[12]

Mr. Chairman, I thank you for this opportunity to testify to the Subcommittee today. I welcome the opportunity to answer questions posed by its members.

[11] This witness discussed the role that monetary policy played in helping to cause the recent U.S. financial crisis in "Bad Rules Produce Bad Outcomes; Underlying Public-Policy Causes of the U.S. Financial Crisis," *Cato Journal*, Vol. 29, No. 1 (Winter 2009), pages 93 to 114.

[12] The Fed's non-monetary-policy functions, such as banking supervision, could be placed elsewhere in the government or, in the case of some of its payment-system activities, privatized.

Biographical sketch for Bert Ely

Bert Ely has consulted on deposit insurance and banking issues since 1981. In 1986, he became an early predictor of the S&L crisis and a taxpayer bailout of the FSLIC. In 1991, he was the first person to correctly predict the non-crisis in commercial banking.

Bert continuously monitors conditions in the banking industry as well as monetary policy. In recent years, he has focused increased attention on banking problems, the crisis in housing and housing finance and the entire U.S. financial system, and the resolution of the Fannie Mae and Freddie Mac conservatorships. More recently, he has been advising clients on the implementation and consequences of the Dodd-Frank Act.

Bert has testified on numerous occasions before congressional committees on banking issues and he often speaks on these matters to bankers and others. He is interviewed by the media on a regular basis about banking and other financial issues.

Bert first established his consulting practice in 1972. Before that, he was the chief financial officer of a public company, a consultant with Touche, Ross & Company, and an auditor with Ernst & Ernst. He received his MBA from the Harvard Business School in 1968 and his Bachelor's degree in economics in 1964 from Case Western Reserve University.

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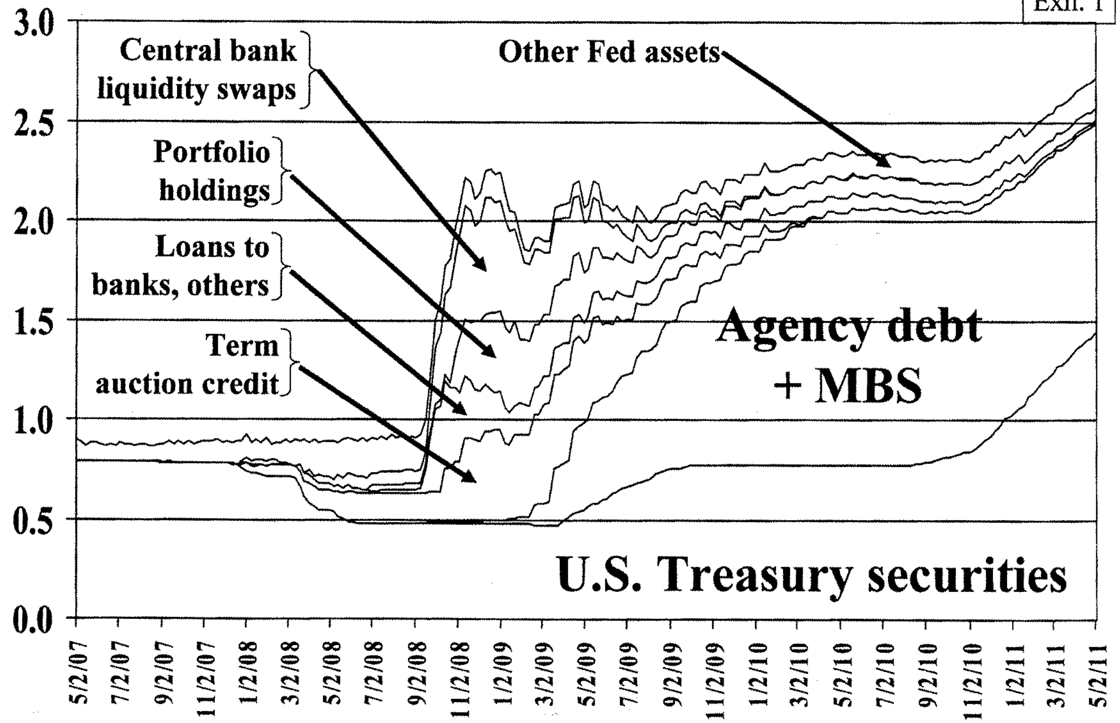
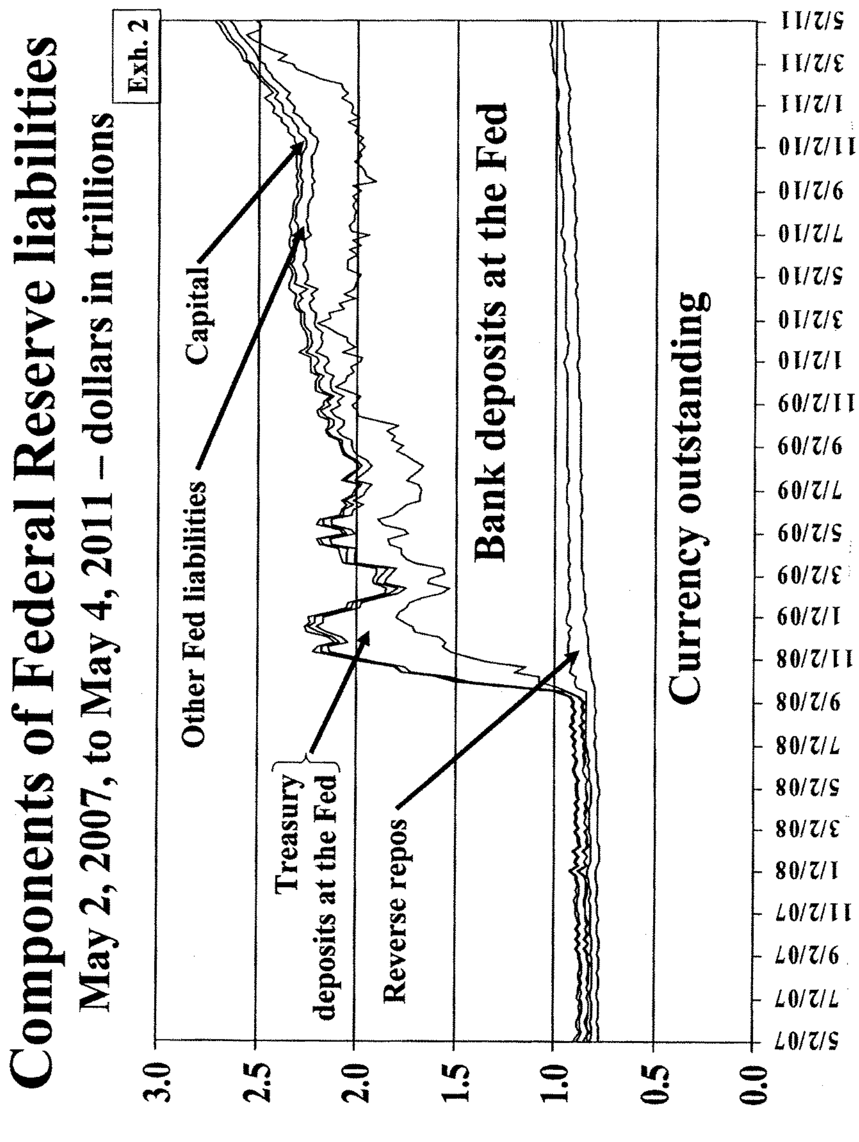
Components of Federal Reserve assets

May 2, 2007, to May 4, 2011 – dollars in trillions

Exh. 1




Components of Federal Reserve liabilities
May 2, 2007, to May 4, 2011 – dollars in trillions
Exh. 2
Capital
Other Fed liabilities
Treasury deposits at the Fed
Reverse repos
Bank deposits at the Fed
Currency outstanding
3.0
2.5
2.0
1.5
1.0
0.5
0.0
5/2/07
7/2/07
9/2/07
11/2/07
1/2/08
3/2/08
5/2/08
7/2/08
9/2/08
11/2/08
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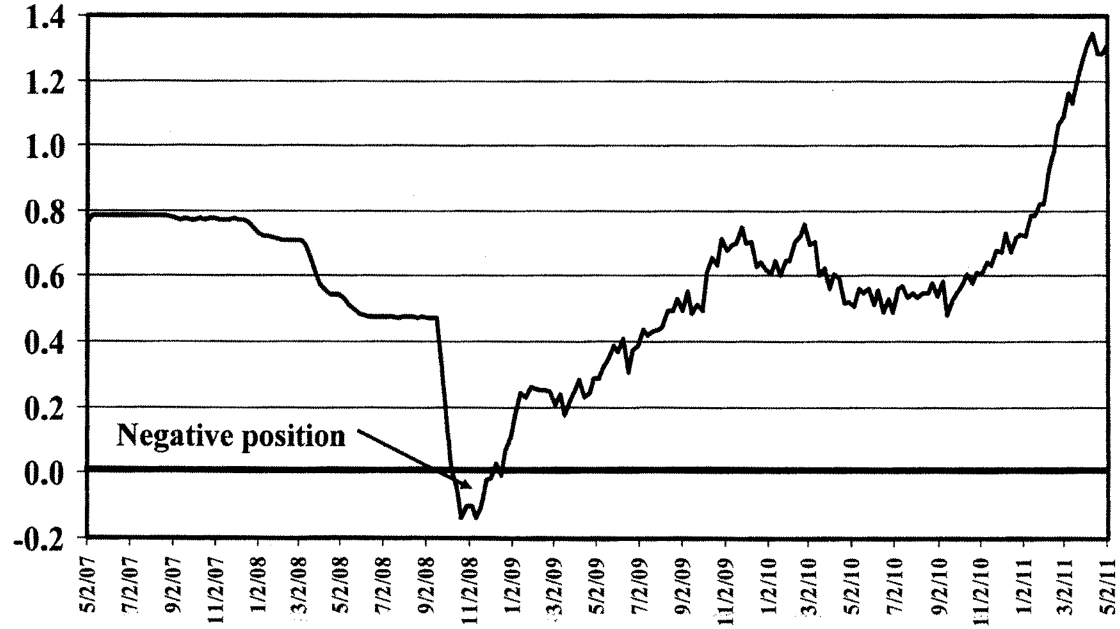
11/2/09
1/2/10
3/2/10
5/2/10
7/2/10
9/2/10
11/2/10
1/2/11
3/2/11
5/2/11

Net Treasury Position (NTP)at the Fed

Treasury securities owned by the Fed minus Treasury deposits at the Fed

May 2, 2007, to May 4, 2011 – dollars in trillions

Exh. 3



The Fed balance sheet grew enormously as it intermediated private-sector credit risk

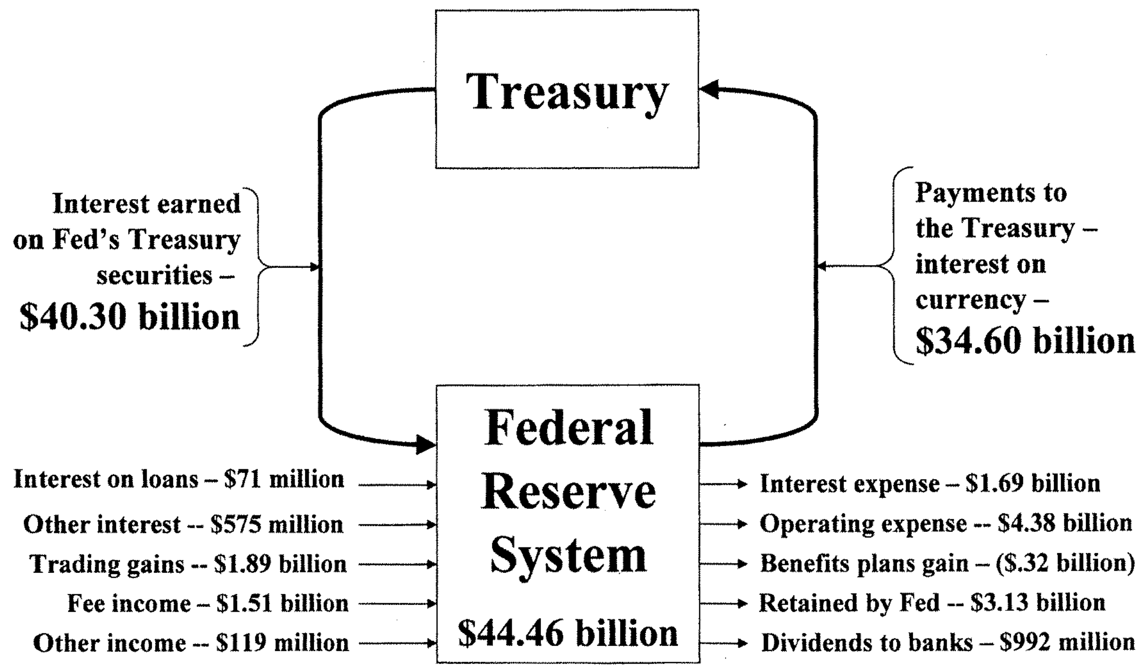
Exh. 4

Dollars in billions

	6-6-07	6-3-09		5-3-11	
Treasury securities	790	606		1,442	
Agency debt, MBS	0	510		1,052	
Term auction credit	0	373		0	
Other loans	.154	124	1,213	16	1,133
Commercial paper	0	143		0	
Maiden lane portfolio holdings	0	63		65	
Other assets, repo agreements	78	261		148	
Total assets	878	2,080		2,723	
Currency outstanding	776	869		976	
Bank deposits (reserves)	19	845		1,481	
Treasury deposits	5	238		130	
Other liabilities, reverse repos	45	82		83	
Capital	33	46		53	
Total liabilities and capital	878	2,080		2,723	

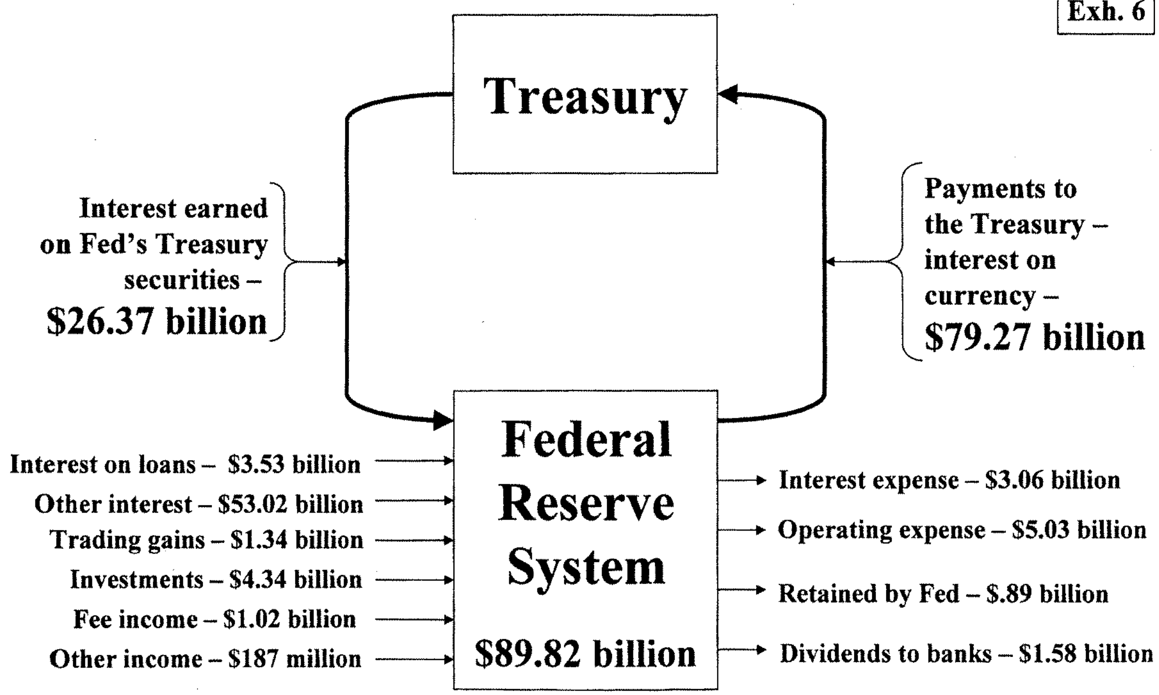
Taxpayers historically subsidized Fed activities
The Fed's 2007 subsidy equaled $5.7 billion

Exh. 5



The Fed made $52.9 billion in 2010 because of credit, market risks it (taxpayers) assumed

Exh. 6



Changes in the Fed's income statement from 2007 to 2010

Exh. 7

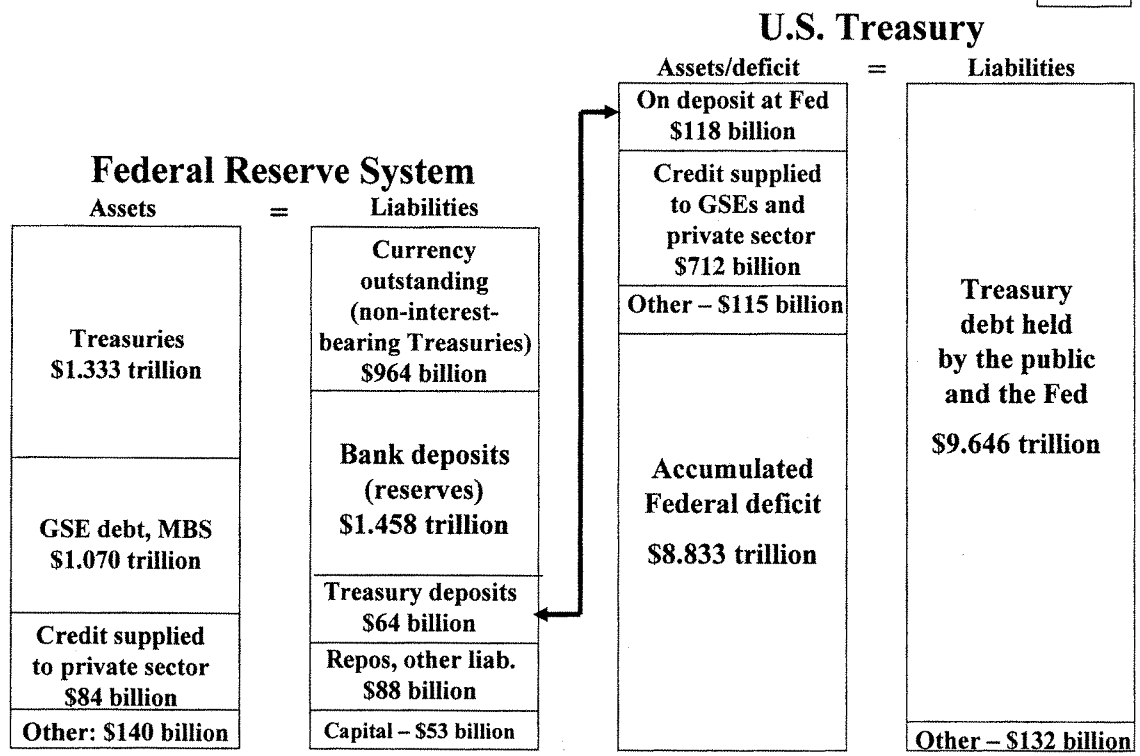
(Dollars in billions)

Income side	Interest income earned on Treasury securities	- 13.93
	Interest earned on loans	+ 3.46
	Other interest income	+ 52.45
	Trading gains	- .55
	Investments	+ 4.34
	Fee and other income	-.42
Expense side	Interest expense	+ 1.37
	Operating expenses (including benefit plans)	+ .97
	Retained by the Fed as capital surplus	- 2.24
	Dividends paid to banks	+ .59
	Payment to the Treasury	+ 44.67

Fed and Treasury balance sheets

(As of March 30, 2011, for the Fed and March 31, 2011, for the Treasury – Not to scale)

Exh. 8



Consolidated Fed/Treasury balance sheet

(As of March 30, 2011 [Fed] and March 31, 2011 [Treasury] – Not to scale)

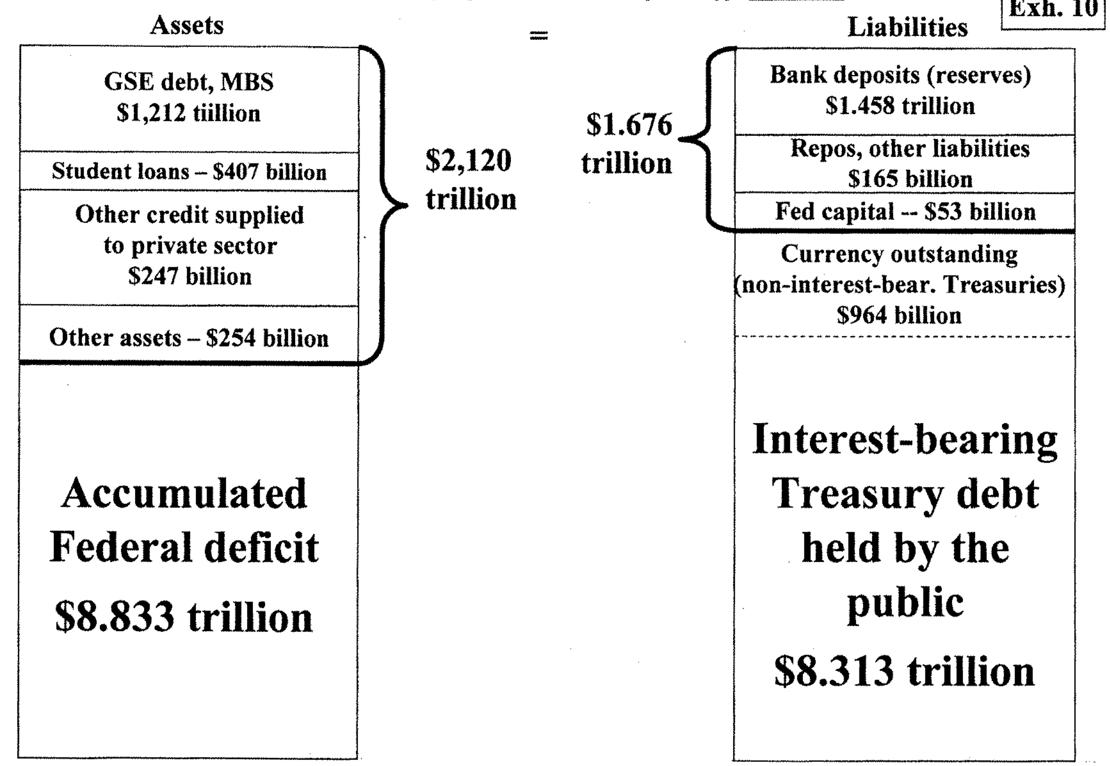
Exh. 9

Assets	=	Liabilities
GSE debt, MBS $1,212 tiillion		Bank deposits (reserves) $1.458 trillion
Student loans – $407 billion		Repos, other liabilities $165 billion
Other credit supplied to private sector $247 billion		Fed capital -- $53 billion
Other assets – $254 billion		Currency outstanding (non-interest-bear. Treasuries) $964 billion
Accumulated Federal deficit **$8.833 trillion**		**Interest-bearing Treasury debt held by the public** **$8.313 trillion**

Consolidated Fed/Treasury balance sheet

(As of March 30, 2011 [Fed] and March 31, 2011 [Treasury] – Not to scale)

Exh. 10



United States House of Representatives
Committee on Financial Services
Subcommittee on Domestic Monetary Policy and Technology

Testimony of Matthew J. Slaughter
"Monetary Policy and the Debt Ceiling:
Examining the Relationship Between the Federal Reserve and Government Debt"

Wednesday, May 11, 2011 2128 Rayburn House Office Building

Committee Chairman Bachus, Committee Ranking Member Frank, Subcommittee Chairman Paul, Subcommittee Ranking Member Clay, and fellow members, thank you very much for inviting me to testify on these important and timely issues regarding America's monetary and fiscal policies.

My name is Matt Slaughter, and I am currently Associate Dean and Signal Companies' Professor of Management at the Tuck School of Business at Dartmouth, Research Associate at the National Bureau of Economic Research, and Senior Fellow at the Council on Foreign Relations. From 2005 to 2007 I also served as a Member on the Council of Economic Advisers, where my international portfolio spanned topics on the competitiveness of the American economy.[1]

For today's hearing, you requested that I comment on "the relationship between the Federal Reserve and Federal government debt, including how the Federal Reserve finances portions of government debt and how Federal Reserve purchases of Treasury debt are used as a basis for conducting monetary policy."

In my remarks, I will make two points regarding the relationship between the Federal Reserve and Federal government debt. I will then make two broader points regarding the debt ceiling.

First, it is important to emphasize that Federal Reserve purchases of Federal government debt has for generations been standard operating procedure for how the Fed conducts monetary policy. In pursuit of its dual mandate of both price stability and full employment, in the normal course of operations the Fed has long bought or sold Treasury securities to increase or decrease the supply of what is commonly called "high powered money" or the "monetary base." In turn, through rounds of lending in the private financial system, these changes in the monetary base expand into changes in the broader U.S money supply and thus in economic activity.

[1] Currently and in the past two years, I have not received any Federal research grants. Currently, in addition to the affiliations listed above I serve as a member of the academic advisory board of the International Tax Policy Forum; an academic advisor to the Deloitte Center on Cross-Border Investment; an academic advisor to the Organization for International Investment, and a member of the U.S. State Department's Advisory Committee on International Economic Policy. For many years I have consulted both to individual firms and also to industry organizations that support dialogue on issues of international trade, investment, and taxation. For a listing of such activities, please consult my curriculum vitae posted on my web page maintained by the Tuck School of Business at Dartmouth.

Indeed, for many years before the World Financial Crisis the Fed executed monetary policy almost exclusively by transacting Treasury securities—and so Treasurys accounted for a very large share of the Fed's balance sheet. Thus did the Fed report that as of January 23, 2008, 82.1% of all the Fed's assets—$723.3 billion of $881.0 billion—were Treasury securities. There is nothing inherently nefarious or worrisome about the Fed owning such a large amount of Federal government debt. Rather, the deep liquidity of Treasurys has long supported the Fed's ongoing policy efforts.

Second, it is important to emphasize that the current fiscal challenges facing America have not been caused or abetted by the historic interventions the Federal Reserve undertook amidst the World Financial Crisis. The Fed's efforts to restore liquidity and stability to America's capital markets required it to expand both the size and asset composition of its balance sheet in several unprecedented ways. As of last week, the Fed's holdings of U.S. Treasury securities stood at approximately $1.442 trillion: about double the amount of Treasurys it held on the eve of the Crisis. But the overall Fed balance sheet has more than tripled during this time, standing today at about $2.763 trillion.

This historic expansion of Federal Reserve monetary policy did not somehow cause the commensurate historic fiscal expansion. Rather, massive fiscal federal deficits were triggered by a combination of sharp downfalls in federal tax receipts and especially sharp increases in federal spending. Tax receipts fell precipitously because of declines in labor income, in corporate profitability, and in asset returns of many kinds. Spending increased sharply both because of automatic stabilizers built into existing law (e.g., unemployment insurance) and because of new spending authorized by, for example, the 2009 American Recovery and Reinvestment Act. Thus, historic monetary expansion has coincided with historic fiscal expansion. But neither has directly caused the other. Rather, both have been directed at containing the damage to the real U.S. economy of the World Financial Crisis. History does offer grim examples where central banks have excessively monetized runaway fiscal deficits when too few buyers of government debt materialized—and thus spawned hyperinflation: Germany in the early 1920s or Zimbabwe in recent years. Thanks in large part to the ongoing sound leadership of Federal Reserve Chairman Ben S. Bernanke and his colleagues, such a catastrophe remains a near-impossibility in America today.

Let me turn now to the broader issue of America's looming debt ceiling. Here I want to make two points, the importance of which it is difficult for me to over-stress.

First, the decision to lift the debt ceiling is a necessary consequence of previous decisions on taxes and spending. If America does not want to default on its existing debt obligations, then raising the debt ceiling is mandatory, not optional. Pick whichever deficit-reduction plan you like: that of the bi-partisan Deficit Reduction Panel, that of Congressman Paul Ryan, that of President Obama. No matter which deficit-reduction plan currently being floated you like, that plan will expand the total federal debt outstanding by several trillion dollars over the next decade. This means that no matter which plan you like, to see it become reality without the United States defaulting on its outstanding debt you must support increasing the debt ceiling.

Some might ask, couldn't a deficit-reduction plan be crafted and implemented that would create fiscal balance and thus prevent America from breaching its looming debt ceiling? Speaking practically, the answer is no. As of May 3 the total amount of federal debt outstanding was about $14.28 trillion. The debt limit is $14.294 trillion. Even if America wanted to do so, there simply is not enough calendar time for America to rewrite its spending and taxing laws to prevent reaching this limit. Speaking economically, the answer should also be no. There is no doubt that America must soon control its massive fiscal deficits. But doing so immediately would require such a massive combination of spending cuts and/or tax increases that it would almost surely throw America back into a deep recession. This real economic hardship on American workers and families would not be worth enduring for the sake of immediate fiscal balance.

My second and final point is to implore you to understand that America is tempting a crisis of unknowable proportions if we default on our Federal government debt. In many ways, global capital markets today remain deeply impaired by the World Financial Crisis. Housing prices in the United States and other countries continue to decline towards an unclear bottom—while in other countries such as Canada and China escalating housing prices are raising worries of new bubbles. Several sovereign debtors in Europe are struggling to remain liquid and solvent amidst widening concern among creditors. Central banks such as the Federal Reserve continue to provide historic support to the global financial system.

At the same time, economic recovery remains tentative in the United States and in many other advanced countries. About 25 million Americans—nearly one in six in the entire labor force—remain unemployed or under-employed. Today's 108.9 million private-sector jobs is the same number America had nearly 12 years ago, in August 1999. And the last time America had just 11.7 million manufacturing jobs, like we do today, was in April of 1941. Median household income in 2009, at $49,777, was barely above where it was in 1997. All forecasts are that it will take several years of economic growth for the American labor market to fully recover.

Amidst all this fragility and uncertainty, the prospect of a U.S. government default is truly frightening. As the past few years have so painfully demonstrated, financial crises often arise from unexpected forces and metastasize in unknowable ways. And a default on U.S. Treasurys, rather than on some other debt security in the world, would be especially worrisome for two important reasons.

One is that, at least to date, U.S. Treasurys remain the one asset that world investors generally regard to be free of default risk. But there is no law of physics that states the world's risk-free asset will always be U.S. Treasurys. Indeed, it was not always so. Over much of the 19th century the world's risk-free asset was widely regarded to be the debt securities of the British government. Over time, in part because of how the U.K. economy lost ground to the U.S. economy, world perceptions shifted and U.S. Treasurys came to hold that special position. This position is not a right of nature, however. A default on Treasurys would almost surely upset this position, with unknowable consequences for the function of global capital markets.

The other is that creditors holding U.S. government debt are increasingly foreigners, not domestic savers. Today the amount of Federal debt held by the public is approaching $10 trillion. It is now widely estimated that the United States has recently crossed the threshold at which foreign savers hold at least 50% of this public debt. Thanks to ongoing low saving rates by U.S. households, this foreign share of U.S. government debt is likely only to rise. The single largest foreign creditor appears to be China's central bank, the People's Bank of China, with a current holding of Treasurys of about $1.5 trillion. Other major foreign creditors include other central banks, such as the Bank of Japan, and sovereign wealth funds. All of this matters because history shows that deeply indebted sovereign borrowers are more likely to encounter sudden losses of confidence the larger is the share of outstanding debt held by foreign creditors.

In response to all these warning signs, some scoff and point to today's low Treasury interest rates: "The full faith and credit of the U.S. government remains on display in today's low interest rates. Markets are not worried about a possible default. Why should we?" My reply to this argument is history. Fiscal crises have often come sharply and with little warning. All is okay; all is okay; all is okay. And then, one day, all is catastrophically not okay. Markets are not omniscient. Low interest rates today do not guarantee against interest rates spiking tomorrow if our creditors lose confidence in America's leaders. Do we really want to risk all the damage this might cause—to asset prices, to capital markets, to the jobs and well-being of American workers and their families?

America's fiscal challenges are grave. We will need the understanding of our creditors—domestic and, increasingly, foreign—to overcome these challenges. As such, America should be doing everything in its power to not cast doubt on the pledge to honor our debts. Time is running short. What America needs most of all is leaders—such as those of you on this committee—to raise America's debt ceiling as part of meeting its fiscal challenges: by acknowledging the problems, by imagining solutions to these problems, and by manufacturing the tangible steps needed to realize these solutions.

Let me close by thanking you again for your time and interest in my testimony. I look forward to answering any questions you may have.

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