**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


By Dr. Richard M. Ebeling
Professor of Economics
Northwood University
Midland, Michigan 49640


## 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 where pushed far below any historical levels.

For a good part of the 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 economy's actual product 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 last year, 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 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 he 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 the 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 be 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 the 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

[i] *The 2011 Statistical Abstract: The National Data Book* (Washington, D.C.: U.S. Census Bureau, 2011), Table 669, http://www.census.gov/compendia/statab/2011/tables/11s0669.pdf
[ii] Richard M. Ebeling, Why Government Grow: The Modern Democratic Dilemma," *AIER Research Reports*, Vol. LXXV, No. 14 (Great Barrington, MA: American Institute for Economic Research, August 4-18, 2008); James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (New York: Academic Press, 1977); and earlier, Henry Fawcett and Millicent Garrett Fawcett, *Essays and Lectures on Social and Political Subjects* (Honolulu, Hawaii: University Press of the Pacific, [1872] 2004), Ch. 6: "National Debts and National Prosperity," pp. 125-153.
[iii] *The Budget and Economic Outlook: Fiscal Years 2011 to 2021* (Washington, D.C.: Congressional Budget Office, January 27, 2011)
[iv] Richard M. Ebeling, "Brother, Can You Spare $43 Trillion? America's Unfunded Liabilities," *AIER Research Reports*, Vol. LXXVI, No. 3 (Great Barrington, MA: American Institute for Economic Research, March 2, 2009), pp. 1-3.
[v] Michael D. Tanner, "The Coming Entitlement Tsunami." April 6, 2010. http://www.cato.org/pub_display.php?pub_id=11666 (accessed May 5, 2011).
[vi] For more details, see, Richard M. Ebeling, "The Financial Bubble was Created by Central Bank Policy," American Institute for Economic Research, November 5, 2008, http://www.aier.org/research/briefs/667-the-financial-bubble-was-created-by-central-bank-policy (accessed on May 5, 2011).
[vii] See, Richard M. Ebeling, "Market Interest Rates Need to Tell the Truth, or Why Federal Reserve Policy Tells Lies," in Richard M. Ebeling, Timothy G. Nash, and Keith A. Pretty, eds., *In Defense of Capitalism* (Midland, MI: Northwood University Press, 2010) pp. 57-60; http://defenseofcapitalism.blogspot.com/2009/12/market-interest-rates-need-to-tell.html
[viii] Thomas Sowell, *The Housing Boom and Bust* (New York: Basic Books, 2010); Johan Norberg, *Financial Fiasco* (Washington, D.C.: Cato Institute, 2009).
[ix] Richard M. Ebeling, "Is Consumer Credit the Next Bomb in the Economic Crisis?" American Institute for Economic Research, October 22, 2008, http://www.aier.org/research/briefs/599-consumer-credit-the-next-qbombq-in-the-economic-crisis (accessed May 5, 2011).
[x] *Monetary Trends* (St. Louis, MO: St. Louis Federal Reserve, May 2011)
[xi] See, Richard M. Ebeling, "The Hubris of Central Bankers and the Ghosts of Deflation Past" July 5, 2010, http://defenseofcapitalism.blogspot.com/2010/07/hubris-of-central-bankers-and-ghosts-of.html (accessed May 5, 2011)
[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.

[xiii] See, Richard M. Ebeling, "The Cost of the Federal Government in a Freer America," *The Freeman: Ideas on Liberty* (March 2007), pp. 2-3; http://www.thefreemanonline.org/from-the-president/the-cost-of-the-federal-government-in-a-freer-america/ (accessed May 5, 2011).

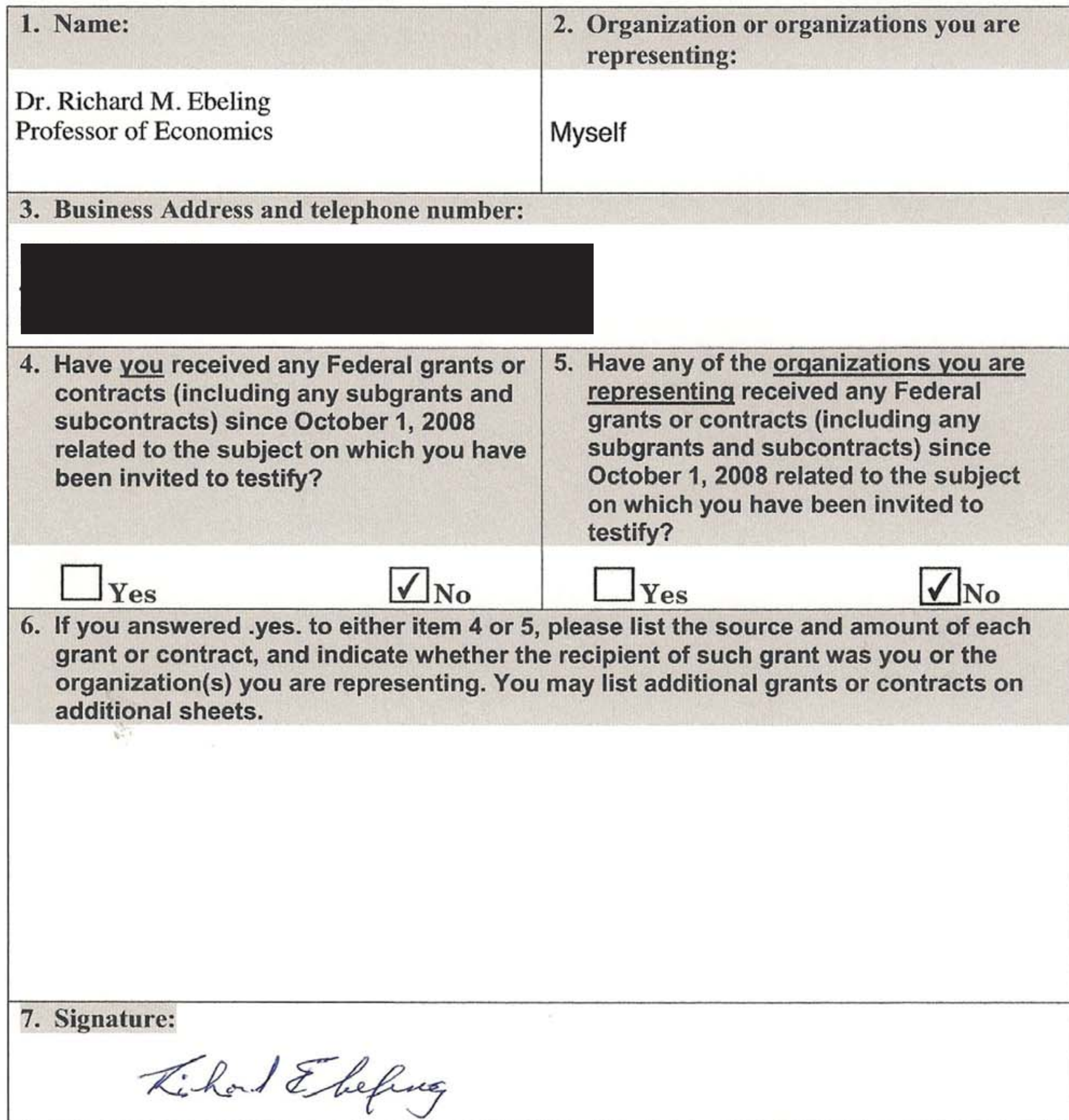
[xiv] See, Richard M. Ebeling, "The Gold Standard and Monetary Freedom," March 30, 2011, http://defenseofcapitalism.blogspot.com/2011/03/gold-standard-and-monetary-freedom-by.html

[xv] See, Richard M. Ebeling, "Real Banking Reform? End the Federal Reserve," January 22, 2010, http://defenseofcapitalism.blogspot.com/2010/01/real-banking-reform-end-federal-reserve.html

United States House of Representatives
# Committee on Financial Services

## "TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.



| 1. Name: | 2. Organization or organizations you are representing: |
|---|---|
| Dr. Richard M. Ebeling<br>Professor of Economics | Myself |
| 3. Business Address and telephone number: | |
| [redacted] | |
| 4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? | 5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? |
| ☐ Yes ☑ No | ☐ Yes ☑ No |
| 6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets. | |
| | |
| 7. Signature: | |
| Richard Ebeling | |

*Please attach a copy of this form to your written testimony.*