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
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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.