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.

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[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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1. Name:	**2. Organization or organizations you are representing:**
Matthew J. Slaughter	Tuck School of Business at Dartmouth
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.	
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