

On a Path to Crisis

Allan Meltzer Testimony, Subcommittee on Monetary Policy and Trade,
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Our Constitution assigns responsibility for monetary policy to the Congress. The Federal Reserve acts as your agent. The Federal Reserve has expanded bank reserves by more than 350% in the last few years. This is an enormous and unprecedented increase. And it continues.

In my opinion, no entity or agent in our government should have so much unrestrained authority. Current practice violates all our beliefs about checks and balances. It sets a terrible precedent that should be avoided. It carries high costs. And it achieves very limited benefits to our economy.

Many bankers applaud the current, expansive policy. They profit from it because they can borrow from the Fed or in the money market at ¼% or less and lend to the Treasury at 1% or more. They are able to improve their stock prices by paying dividends and increase their incomes by paying bonuses. Does the Congress approve this transfer from taxpayers to the owners and managers of financial firms?

Chairman Bernanke describes the expansive program as on balance of benefit to the economy. I disagree for several reasons.

First, we agree that the low interest rate policy encourages risk taking. But among those increasing their investment risk are retirees who cannot live on the income they receive currently from their usual source of investment, often bank certificates of deposit. Many are said

to seek higher income by investing in emerging market bonds or domestic junk bonds. We know from our history how this practice ends. It ends in losses and tears when interest rates rise, bond prices fall and risky assets default. Or, note what has happened to the prices of farmland, in part a result of the ethanol program that raised agricultural prices. We have seen this pattern of rising farmland prices many times. It has ended in tears and heavy losses many times.

These are examples of a general pattern. Increasingly investors do not want to hold money or low interest rate bonds. They shift into holding equities, raising equity prices and take the risk of holding high yield bonds or claims on farmland, or other risky assets.

Federal Reserve policy is repeating the same mistake that brought us the Great Inflation of the 1970s. Then, and now, the Federal Reserve expanded its balance sheet by financing the government's budget deficits. This time the deficits are larger and the Fed's purchases are much, much larger. And then, as now, the Fed tried to push unemployment rates down. Doing so, they ignore the lesson that Paul Volcker repeated many times: low expected inflation is the way to get low inflation.

We know from that experience and repeated experiences all over the world how highly expansive policy ends. It ends with inflation, followed by a big recession required to end the inflation by reducing money and credit growth and raising interest rates. Ask yourselves, please, what you expect to happen to all the low interest rate bonds that the banks and others hold? Will they all have enough equity reserves to absorb the losses? Or will there be another debt crisis?

The first Federal Reserve balance sheet expansion in 2008 prevented a breakdown of the payments system. That was the right thing to do. The next large balance sheet expansion, called QE 2, added \$ 600 billion to bank reserves and the Federal Reserve balance sheet. \$ 500 billion went into bank excess reserves. That pays some interest to the bankers but does absolutely nothing for employment and economic activity. Much of the remaining \$100 billion went into reserves of foreign central banks. They bought the dollars to limit the depreciation of the dollar against their currency. Other central banks are now expanding reserve growth rapidly. This prevents currency appreciation.

We are now in a third round of QE expansion. Since September bank reserves increased about \$ 100 billion dollars. Bank loans to business, called C&I loans, increased a bit during this period, about \$ 65 billion— or a modest 5 percent. Again, most of the addition to reserves became idle bank excess reserves. The Federal Reserve pays the banks ¼% on the idle balances they hold at Fed banks.

Why does Chairman Bernanke claim greater benefits than costs? Mainly, he makes the mistake of looking only at interest rates, never mentioning what happens to growth of credit and money. He has kept short-term interest rates near zero and lowered long-term rates. But now long-term rates have started to rise as QE3 gets underway and owners of government and other debt begin to show concern about future inflation. The measure of expected inflation shown in bond yields has moved up steadily for the past six months. It remains low at present but is rising.

Chairman Bernanke assures members of Congress and the public that he has the proper tools to prevent inflation, when it rises. The Fed

proposes to increase the interest rate it pays on the nearly \$ 2 trillion dollars of excess reserves. He never tells how high that rate would go and what the increase in all interest rates would do to government spending, output and employment. When that happens, you will want to know. I suggest that you should want to know now.

The United States has an unsustainable budget deficit. Higher interest rates will increase the budgeted cost of servicing our enormous debt. As interest rates rise so do the interest payments on the outstanding debt as the outstanding debt is retired and replaced at higher interest rates. I calculate that 40% of the debt has less than 2 years to maturity. A 3 percentage point increase in rates would increase the budget deficit by about \$ 140 billion a year. That cost would rise further as more of the debt is refunded. My estimate does not include the losses on Federal Reserve holdings that reduce the payment of interest income to the Treasury or other interest payments that are not part of direct Treasury debt. Since much of our debt is held abroad, the current account deficit of the balance of payments would rise about \$ 40 billion a year.

Let me close with this comment. The Federal Reserve will be 100 years old this year. Its history includes only two multi-year periods during which inflation was low, real income and employment fluctuations were modest, and recessions were mild. The two periods are 1923-28 and 1985-2002. In both periods, the Federal Reserve generally followed a monetary rule. In 1923-28 the rule was the gold-exchange standard. In 1985-2002 or 2003, the rule was the Taylor rule.

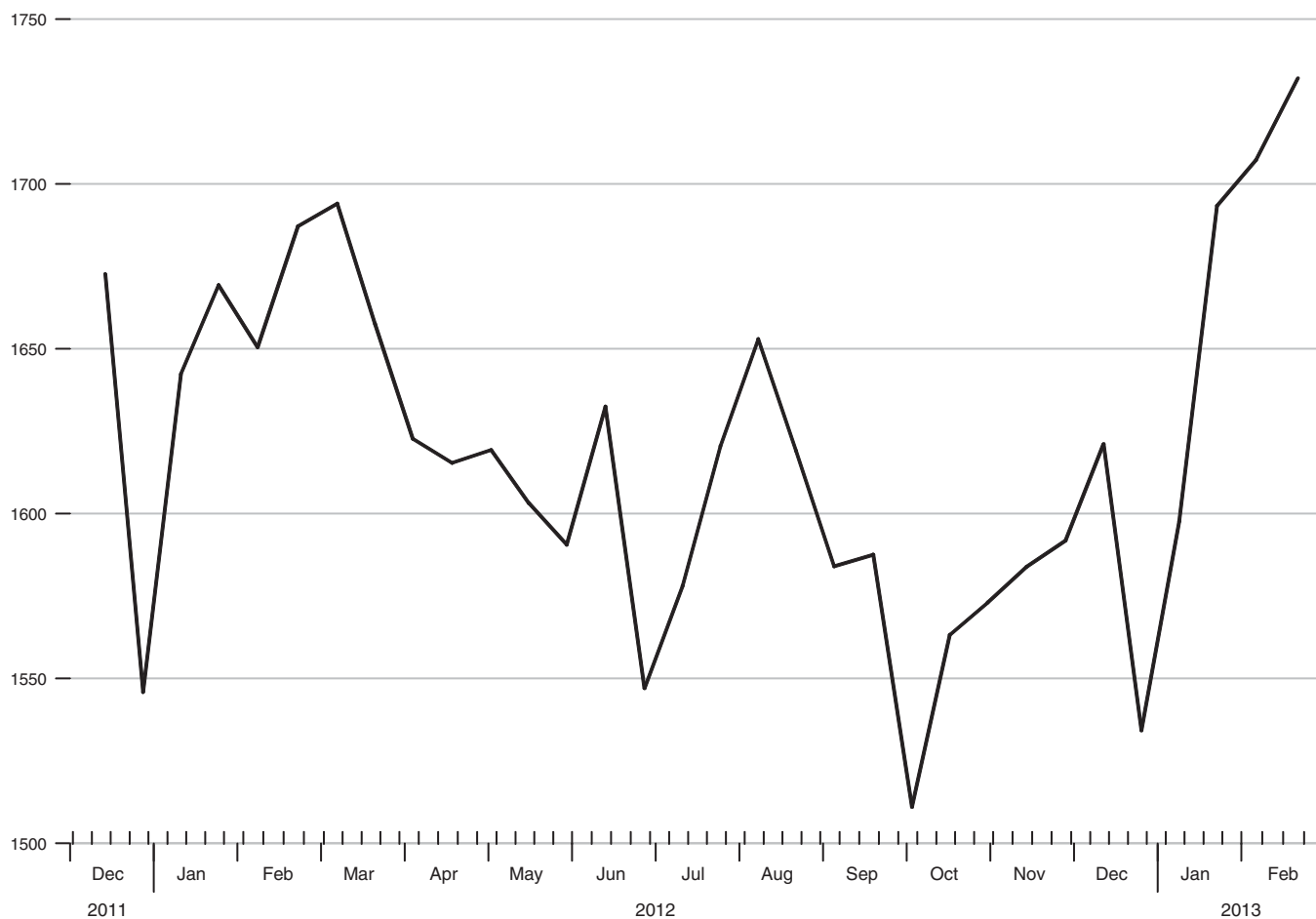
No rule will be perfect all the time. But the lesson you should draw is that following a rule gives much better results for the public and the

country than policies based on forecasts and judgments. That's a lesson that you should discuss and implement as you consider how to get off the path to crisis and improve on your responsibility for regulating the Federal Reserve and its monetary policy.

Adjusted Reserves

Seasonally Adjusted

Billions of dollars

**Adjusted Reserves**To the average of
two maintenance
periods ending:

Compounded annual rates of change, average of two maintenance periods ending:

	02/22/12	05/16/12	07/25/12	08/22/12	09/19/12	10/17/12	11/28/12	12/26/12
07/25/12	-9.6							
08/22/12	-3.9	5.8						
09/19/12	-8.5	-4.5	-5.4					
10/17/12	-11.8	-10.5	-15.8	-33.3				
11/28/12	-6.3	-2.7	-2.1	-10.5	0.7			
12/26/12	-6.4	-3.4	-3.2	-10.0	-1.9	14.5		
01/23/13	-1.5	3.1	5.9	1.4	11.3	28.8	26.1	
02/20/13	3.0	8.8	13.4	10.5	21.1	38.3	41.3	75.1