By Reuven Brenner and Martin Fridson

Treasury's Little Buddy

The Federal Reserve's World War II-style monetary regime is both not working and producing extraordinary inequality.

When governments spend beyond their means, be it due to wars or by compounding mistakes, the options for paying for the spree are unattractive. Governments can impose higher taxes; can wipe out a portion of bondholders' wealth by inflating and devaluing, repaying debts with a debased currency; or can do a combination of the above. Not for the first time in its history, the United States has managed to avoid either of these choices for now. Using the Federal Reserve's toolkit, the government lowered its interest cost from $451.2 billion in FY2008 to $415.7 billion in FY2013, even as the federal debt soared from $10 trillion in 2008 to $17 trillion in 2013.

Though Fed Chairman Ben Bernanke has likened the "quantitative easing" policy to the monetary regime adopted during the 1940s, the analogy he draws is mistaken: He has been carrying out fiscal policy—simple, though not so pure. In a 2002 speech, he declared that the Fed policies were successful during 1940–1951, but he fails to point out that the Treasury imposed

Reuven Brenner holds the Repap Chair at McGill's Desautels Faculty of Management. This article draws on his books Force of Finance *(2002),* Labyrinths of Prosperity *(1994), and* World of Chance *(2008). Martin Fridson is CEO of FridsonVision LLC, and Special Assistant to the Director for Deferred Compensation, Office of Management and the Budget, City of New York.*

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E.
Suite 200
Washington, D.C. 20002
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

them to pay down the debts of World War II, and the Fed was not an independent entity then:

> *"Historical experience tends to support the proposition that a* sufficiently determined *Fed can peg or cap Treasury bond prices and yields at other than the shortest maturities. The most striking episode of bond-price pegging occurred during the years before the Federal Reserve-Treasury Accord of 1951. Prior to that agreement, which freed the Fed from its responsibility to fix yields on government debt, the Fed maintained a ceiling of 2.5 percent on long-term Treasury bonds for nearly a decade. … The Fed was able to achieve these low rates despite a level of outstanding government debt (relative to GDP) significantly greater than we have today. … At times, in order to enforce these low rates, the Fed had actually to purchase the bulk of outstanding 90-day bills." [emphasis added].*

Well, no. Bernanke is wrong. The pegging had nothing to with a "sufficiently determined Fed," but with a very determined Treasury that was worried about the budgetary impact of higher interest rates. The Fed was actually carrying out its policy under strict orders from the Treasury, even though by 1948 it was warning about the rise in inflation (which the official numbers underestimated because of price controls). Marriner Eccles, the Federal Reserve chairman at the time, testified that "under the circumstances that now exist, the Federal Reserve System is the greatest potential agent of inflation that man could contrive." It was only the 1951 agreement with the Treasury that made the Fed more independent. Even then, the Fed had to contend with President Harry Truman and Treasury Secretary John Snyder's staunch defense of the low interest rate peg. They wanted the Fed to finance the Korean War the same way it helped finance World War II.

Briefly: The Fed was executing a fiscal policy to help pay for World War II and, after 1945, to service the accumulated debt. Patriotism induced 1940s–1950s savers to buy the government's low-coupon bonds, though the Treasury did rely on movie stars, musicians, and Norman Rockwell posters in its pitch for the "Victory Bonds." Nobody was rationalizing the "tax the savers" policy with macroeconomic gobbledygook and new jargon about keeping price levels stable or controlling unemployment. Currently, by contrast, the Fed is avoiding public discussion in clear language and, most recently, is departing from even its official "unemployment" mandate. The Fed is using the orthodox but wildly inaccurate macro jargon to link its "QE" policy to the unprecedentedly low labor participation rate. In its present mode, the Fed is contributing—perhaps inadvertently—both to slowing down the pressure on Washington to find solutions to the fiscal problems the United States is facing, and to raising a host of new, unintended ones.

The Fed is avoiding public discussion in clear language.

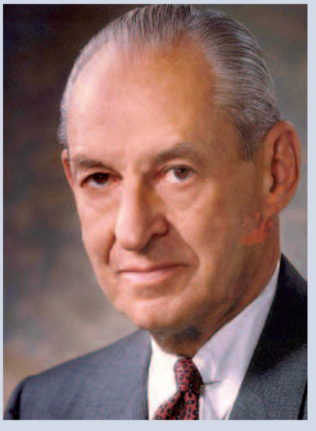
Although Bernanke also suggested that holding down long-term interest rates can work even better nowadays than it did seventy years ago, we believe the opposite to be true. The Fed's present policies are not only having no discernible positive effects, but are laying the foundation for many negative ones. The adverse consequences arise not only from the Fed engaging in fiscal policy, but also from the drastically increased inequality within the United States since 2008.

Several special circumstances during the 1940s helped sustain Fed policies similar to today's without

Pimping for Treasury

The Fed was actually carrying out its policy under strict orders from the Treasury, even though by 1948 it was warning about the rise in inflation (which the official numbers underestimated because of price controls). Marriner Eccles, the Federal Reserve chairman from 1934 to 1948, testified that "under the circumstances that now exist, the Federal Reserve System is the greatest potential agent of inflation that man could contrive."

—R. Brenner and M. Fridson



Marriner Eccles

some of the current side effects. First, the Fed had political support for its actions. To start with, the interest rate policy did not originate with the unaccountable-to-voters Federal Reserve, but was imposed by the U.S. Treasury to finance the war debt as cheaply as possible. Voters understood that governments cannot pick empty pockets after fighting a popular war: savers had to pay the bills. Second, patriotic fervor was abundant and strong support for government spending during the war was not in doubt. Neither of these conditions holds true today: the Fed is acting on its own and voters are far from unanimous in supporting the kind of government spending that triggered the debt accumulation.

A third reason for public acceptance of low bond yields and volatile inflation that Bernanke has alluded to in comparing his policy to that of the 1940s was that the Fed was carrying out its policy in a war economy. The government was rationing consumer items and wage and price controls were in place until 1948. With the government making all of the important output and pricing decisions, managed interest rates did not attract any particular attention; the United States was a centralized, war economy at the time. This is not the case today, even after the centralization of healthcare-related decisions, which represent a significant portion of the U.S. economy.

There is one similarity, though, between then and now, namely, the exceptional position of the United States. There were no other places for savers to put their money during the 1940s decade, as Europe lay in ruins and the rest of the world was financially inaccessible. America was then the safest place in the world and, after the war, the destination for many of the world's ambitious and talented people, too.

Today the Fed, along with the government, is in the fortunate position, at least for now, of being able to mimic the World War II-era strategy, though under veils of misleading macroeconomic jargon. Now as then, the Fed's policy allows the Treasury to continue borrowing cheaply, buying time to avoid tough spending and taxing decisions, while continuing to run deficits and accumulate debt. Also, now as during the decade of the 1940s, a significant portion of savers both in the United States and around the world have few places to park their money safely. Europe and the euro have lost considerable credibility since 2008, as has Japan, with its moribund economy, aging population, and its deteriorating currency. China continues under one-party rule, India is still bound in red tape, Russia remains an enigma, and much of Latin America is not yet quite reliable. Australia, Canada, Switzerland, and the rest of the world can absorb only so much of worldwide savings. This global serendipity enables the Fed to keep interest rates low to finance federal spending and allows the U.S. dollar to maintain its status as the world's reserve currency. These benefits are accruing not because the United States is pursuing "good policies," but because much of the rest of the world is pursuing worse ones. Additionally, the world still harbors expectations that the United States will correct its policy mistakes faster, recalling the decade of the 1940s.

Bernanke is wrong.

Paul Volcker

Grave Mistake

Paul Volcker's often-stated view, since the crisis in particular, is that assigning the Fed a "dual mandate" of keeping an eye on both price stability and full employment was a grave mistake. The first objective is a technical matter that the central bank can solve with the instruments it has, namely, managing the supply of money and liquidity (the latter to prevent national fire sales). The second is political and would be problematic even if one knew the meaning of "full employment" and what number demonstrates that it has been achieved. As Volcker put it, the dual mandate has proven "both operationally confusing and ultimately illusory."

—R. Brenner and M. Fridson

SPENDING IS THE ISSUE, NOT DEFICITS AND DEBTS

Prices in the global credit markets confirm the above analyses.

The yield on the ten-year Treasury bond has risen from less than 2 percent to almost 3 percent over the last year, as Fitch has watch-listed U.S. government debt, citing the debt ceiling gridlock. Still, these interest rates are low by historical standards, though 1 percentage point higher than on ten-year German bonds.

Even during the gridlock, the three-month Treasury rate rose only from virtually zero to 0.06 percent. The price of credit default swaps, which pay investors if the United States fails to make interest payments on its debt, nearly doubled from 22 cents for every $100 in September to 38 cents during the gridlock week, but that is considerably less than the 65 cents paid per $100 of debt in July 2011. Meanwhile, as previously noted, the Treasury's total interest payments on its outstanding debt for 2013 amount to roughly $415 billion, whereas in 2006 and 2007, when debt levels were much lower than now ($9 trillion versus $17 trillion), the Treasury paid, respectively, $405 billion and $429 billion.

These minor movements, media panic about debt ceilings and deficits notwithstanding, suggest that the problems the United States is facing lie elsewhere.

Consider first the debt ceiling and deficits. Say that the value of a house is $100,000, and the owner has a $40,000 mortgage at 5 percent. The mortgagee who has disposable cash has the option of paying off the debt. He also has the option of remaining in debt and investing the money in hopes of earning after-tax returns greater than 5 percent. If the mortgagee expects returns of more than 5 percent, he is better off

The Fed's present policies are not only having no discernible positive effects, but are laying the foundation for many negative ones.

not liquidating the debt—or perhaps even taking on greater leverage—and investing in higher-expected-return assets. If he postpones repayment, the debt principal and interest compound at 5 percent to a sum of $56,284 in seven years. If the homeowner realizes 10 percent on his alternative investment, then over the same seven years he receives $2 for every dollar invested, allowing easier repayment of the debt (whereas every $1 in his mortgage would compounds to $1.4 in seven years, assuming the 5 percent).

This same reasoning holds for governments. If—this is a big "if"—the returns on the amounts spent are expected to be higher than the interest rate paid for increased borrowing, the ceiling not only could be raised, but should be: The government could be bor-

Picking some pockets and putting the proceeds into others provides incomes, but does not necessarily create assets.

rowing at 3 percent, lowering taxes, and enabling people to invest the additional discretionary income for, say, a 6 percent return. For these higher returns to be realized, the government must create incentives to spend the borrowed money to build assets that offer a spread over the borrowed funds, rather than spend money to provide "incomes." Picking some pockets and putting the proceeds into others provides incomes, but does not necessarily create assets. If the government follows this course, the debt compounds, and since no assets are created, the country ends up in a worse position, having less taxable wealth to back its increased debt.

Today's special circumstances, combined with the Fed's World War II-style monetary regime, allow the government to buy time and continue its present policy. However, if the time is not used to make the needed fiscal and regulatory changes and the building of assets does not happen, debt will continue compounding, and will not be backed by future assets.

Looked upon from this perspective, deficits are not the real issue either. The question is what the government does with the money. If it spends responsibly and voters expect errors to be corrected swiftly, "deficits" would pose no greater problems than any start-up company's increased "deficits" do. The same applies to not-quite-start-ups too, such as Amazon, Facebook, and Netflix: In spite of their increased borrowing and lack of positive cash flows, their valuations have risen. Such "deficits" and higher "debt ceilings" become problematic only when investors lose confidence in the management, too many innovative projects go wrong, or management is either slow or unable to correct its mistakes. Then the stock price drops until the value of the enterprise disappears altogether.

Estimates of growth of real income since 2009 are 30 percent for the top 1 percent and 0.4 percent for the 99 percent below.

But whereas there are many ways in which investors can speed up the correction of management mistakes, be it by the board firing the management or by private equity firms launching friendly or hostile takeovers, in politics there are far fewer mechanisms and they are slower. Nevertheless, the prices observed in the credit markets suggest that for now, at least, both U.S. savers and international investors believe the United States has enough taxable wealth to back its debt.

There are though a few caveats to this optimistic assessment. One is that investors may only appear not to be vigilant since, as in the 1940s decade, they have few options for placing their money. The most likely unraveling under this scenario is that U.S. voters wake up and object to the Federal Reserve carrying out fiscal policy, which is not its mandate.

This brings us to the next caveat, and it concerns the Fed too, though from a different angle. The Fed's present policy, facilitating the continued deficits and increased debt, has not only additional, unintended, and grave fiscal consequences (discussed below), but also violates established principles of accountable central banking. Continued purchases of mortgage-backed securities of dubious value violate the valid mission of a central bank to lend during crises. Historically, "lender of last resort" meant charging high rates for short duration, and only against good collateral. In this crisis, the Fed has instead been charging zero rates against collateral of unknown value, and in the process has become, together with Fannie and Freddie, among the United States' largest financial intermediaries. We do not know at what moment some voters will simply ask when was the Federal Reserve's mandate changed to allow academics—or anyone with only a bureaucratic background and without the slightest experience—to execute financial matchmaking with trillions of dollars day by day?

The unacknowledged, inadvertent impact of the present policy in facilitating a dramatic increase in inequality could speed up the raising of this question, and result in the Fed being assigned a mandate it can actually carry out—of price stability—and holding it accountable for sticking to it.

HOW AN UNACCOUNTABLE FED BRINGS ABOUT INCREASED WEALTH INEQUALITY

Bernanke has explicitly stated that the goal of keeping interest rates abnormally low is to make it expensive for investors to hold "safe assets." This term continues to apply to Treasuries, despite fears of a federal default, minuscule as they might be for now. The idea is to drive people into "riskier" assets, thereby stimulating capital investment. But what were the actions undertaken to achieve Bernanke's policy incentive?

Most baby-boomers staked their retirement on homeownership, pensions, and some savings. When housing prices collapsed and stocks plunged, moving into "riskier" assets became a piece of advice they could not take. In fact, they did the opposite, switching into capital preservation mode. Having lost 30 percent to 40 percent of their assets, citizens nearing retirement could not risk losing more, for fear of facing poverty in old age or being forced to return to work.

Who followed Bernanke's advice? Only those with so much net worth that if the Fed and government policies failed to restore asset values, and instead inflicted additional losses, their standard of living would hardly be affected. Similarly in the pension world, none but the most richly endowed funds could afford to ratchet up their risk to capitalize most fully on the rebound in stocks following the March 2009 trough. It is politically expedient to blame tax policies, free-market ideologues, and "the banks" for the fact that the stock market gains went to a small percentage of the population. This was an unintended consequence of the Fed's policy, disguised by macroeconomics' jargon. Preliminary estimates of growth of real income since 2009 are 30 percent for the top 1 percent and 0.4 percent for the 99 percent below, much of it from gains in implicitly and explicitly Fed-supported stock markets, which should not come as a surprise.

The Fed's low interest rates have also had the effect of facilitating corporate takeovers, further fueling the stock market rally. Mergers and acquisitions have contributed to a roughly 50 percent decline in the number of public companies from 10,000 in 2000. Larger pension funds have responded by entering into long-term limited partnership agreements with private equity sponsors. But only the better-endowed funds can afford the lengthy lock-ins, leaving the rest to live with lower-return investments.

One could defend the perverse wealth redistribution on the grounds that the Fed was pursuing a greater good. However, Bernanke's own words—that he is replicating the 1940s policies—show that any such expectations had no foundations. The Treasury chose the Fed's tools to implement its fiscal policy, not because it was good for either employment or keeping the price level stable, but because it could. The government in the 1940s feared the impact of higher interest rates on the budget, implying—then as now—that government spending, no matter how large, cannot be cut.

WHAT TO DO?

As happened toward the end of the 1940s, the Treasury cannot count on enduring political support for a Fed policy that perpetuates the mistaken spending policies that gave rise to the debt, while bringing about inadvertently a range of grave problems—the one involving increased inequality being just one of them.

True, the disproportionate accumulation of wealth at the top started about two decades ago, having been a predictable outcome of, among other factors, the sudden fall of communism and dictatorial regimes around the world. Those changes diminished the rents many Westerners secured over decades by not having to compete with hundreds of millions of equally skilled people isolated by political barriers. Fed policy since 2008 has added considerable fuel to these latent fires.

The timing of the crisis, with millions of baby boomers preparing to retire and receive money from "pay-as-you-go" entitlement programs, has been putting even more pressure on government spending. These conditions differ drastically from those of 1940–1951. America's population then was younger, less leveraged, less dependent on home equity and entitlements for old age sustenance or other income needs—and, with stock markets in their relative infancy, the Fed's Treasury-dictated policy did not have the unintended consequences it has today. Monetary and fiscal policies that central banks and governments can pursue when talent and capital are relatively immobile are very different from a situation in which they can move.

Now, as in the 1940s, the immobilized savers are effectively being taxed, not because this serves any broader social good, but because there are no effective political mechanisms at present to deal with the government spending problems. The inability to solve them politicized the Federal Reserve, which is now being asked to do things that it cannot do well, and other things that it cannot do at all without creating a host of tougher problems down the line.

We share Paul Volcker's often-stated view, since the crisis in particular, that assigning the Fed a "dual mandate" of keeping an eye on both price stability and full employment was a grave mistake. The first objective is a technical matter that the central bank can solve with the instruments it has, namely, managing the supply of money and liquidity (the latter to prevent national fire sales). The second is political and would be problematic even if one knew the meaning of "full employment" and what number demonstrates that it has been achieved. As Volcker put it, the dual mandate has proven "both operationally confusing and ultimately illusory."

Now, as in the 1940s, the immobilized savers are effectively being taxed.

The risk of defaults is the mother of invention (though stepmother to deceptions too: that is how macroeconomics was born), be it in private life, business, or politics. Perhaps the present crisis, and the Fed's replication of its World War II fiscal policy under the cloak of new monetary jargon building on the wildly inaccurate macroeconomic one, will lead to a re-examination of the Fed's mandate. Congress might finally assign then to the Fed the only task it has the potential to do well: maintaining price stability. ◆