Thomas M Hoenig: Knocking on the central bank’s door

Speech by Mr Thomas M Hoenig, President of the Federal Reserve Bank of Kansas City, to the Peterson-Pew Commission on Budget Reform Policy Forum, Washington DC, 16 February 2010.

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Thank you for the opportunity to join you today, both to attend and to participate in this event on a topic of some urgency.

The United States is moving into an era in which government finance is taking center stage. Fiscal measures taken to bring the economy out of recession, mounting longer-term liabilities for Social Security and Medicare, and other growing demands placed on the federal government have invited a massive buildup of government debt now and over the next several years. Congressional Budget Office (CBO) projections have the federal debt reaching an unsustainable level of two to five times our total national income within the next 50 years, which leads us to an inescapable conclusion – U.S. fiscal policy must focus on reducing this debt buildup and its consequences.

In managing our nation’s debt going forward, it strikes me that we have only three options. First, the worst choice for our long-term stability, but perhaps the easiest option in the face of short-term political pressures: We can knock on the central bank’s door and request or demand that it “print” money to buy the swelling amounts of government debt. Second, perhaps more tolerable politically, although damaging to our economy: We can do nothing so long as domestic and foreign markets are willing to fund our borrowing needs at inevitably higher interest rates. Or third, the most difficult and probably the least palatable politically: We can act now to implement programs that reduce spending and increase revenues to a more sustainable level.

I recognize that this last option involves hard choices and short-term pain. However, in my view it is the responsible path to sustainable economic growth with price stability. The alternative options inevitably lead to financial crisis and greater long-run losses in national income and wealth.

The question of what combination of spending and revenue actions the country might choose is the purview of Congress and the executive branch. As a central banker, it is my responsibility to anticipate and avoid the consequences that an unchecked expansion of the debt may have on monetary policy. It is a fact that the current outlook for fiscal policy poses a threat to the Federal Reserve’s ability to achieve its dual objectives of price stability and maximum sustainable long-term growth, and therefore is a threat to its independence as well.

The founders of the Federal Reserve understood this conflict. They understood that placing the printing press with the power to spend was a formula for fiscal and financial disaster. Aware of this danger, they designed our central bank to be responsible for stable prices and long-term growth, and they gave it a degree of independence so that it could carry out this mandate. The goal of policy cannot be to “just get through” the current challenge, but rather to rebuild the foundation of a stable and prosperous economy, looking to our nation’s long-term future. It is in this context that I appreciate this opportunity to address what I see as our emerging fiscal challenges.

Lessons from history

Throughout history, there are many examples of severe fiscal strains leading to major inflation. It seems inevitable that a government turns to its central bank to bridge budget shortfalls, with the result being too-rapid money creation and eventually, not immediately, high inflation. Such outcomes require either a cooperative central bank or an infringement on its independence. While many, perhaps most, nations assert the importance and benefits of an independent central bank, the pressures of the "immediate" over the goals of the long run makes this principle all too expedient to forgo when budget pressures mount.

German hyperinflation is one classic and often-cited example, and with good reason. When I was named president of the Federal Reserve Bank of Kansas City in 1991, my 85-year old neighbor gave me a 500,000 Mark German note. He had been in Germany during its hyperinflation and told me that in 1921, the note would have bought a house. In 1923, it would not even buy a loaf of bread. He said, "I want you to have this note as a reminder. Your duty is to protect the value of the currency." That note is framed and hanging in my office.

Someone recently wrote that I evoked "hyperinflation" for effect. Many say it could never happen here in the U.S. To them I ask, "Would anyone have believed three years ago that the Federal Reserve would have $1¼ trillion in mortgage back securities on its books today?" Not likely. So I ask your indulgence in reminding all that the unthinkable becomes possible when the economy is under severe stress.

If German hyperinflation seems an unrealistic example from the distant past, then let's come forward in time. Many have noted that in the 1960s, the Federal Reserve's willingness to accommodate fiscal demands and help finance spending on the Great Society and the Vietnam War contributed to a period of accelerating price increases. Although the Federal Reserve was a reluctant participant, it accepted the view that monetary policy should work in the same direction as the Congress and the administration's goals and help finance at least part of their spending programs. Monetary policy accommodation during this period contributed to an increase in inflation from roughly 1½ percent in 1965 to almost 6 percent in 1970. It also helped set the stage for the Great Inflation of the 1970s as inflation expectations gradually became unanchored.

Last Friday, I read that an economist at the IMF raised a question of whether central banks should allow higher rates of inflation during normal times to give them more room to adjust for shocks. While this may sound like a reasonable theory from a credible economist, my concern is that it rationalizes solutions to short-term problems that too often take an economy down the wrong path.

The current US fiscal imbalance

Today, the United States is benefiting from policies that were established in the 1980s to end the Great Inflation. Confidence in the long-run stability of the U.S. economy and the Federal Reserve's commitment to price stability have kept the demand for Treasuries relatively strong, allowing the government to borrow at low interest rates from its citizens and the rest of the world. It would be a mistake, however, to take this current ability for granted and to do nothing about the mounting debt.

While the last 30 years have been relatively stable – at least until recently – our longer-term history is less reassuring. From World War II to the present, nominal federal debt held by the public has increased over 30 fold. And, supported by steady growth in the money supply, the price level has increased by a factor of 12. That's a huge increase in the general price level, and it represents a significant reduction in the purchasing power of the dollar over time. These are matters that demand our attention as we make choices involving both fiscal and monetary policy.

The immediate concern is the size of the deficit. The CBO projects the deficit was almost 12 percent of GDP in fiscal year 2009 and will be almost 8 percent in the current fiscal year – extraordinarily high levels by historical standards. In the entire history of the United States, the government has run deficits over 10 percent of GDP in only a few instances, and usually only during or immediately following a major war.

As troubling as these deficits appear, even more disconcerting is the longer-term outlook for the federal debt caused by the accumulation of these deficits over time. The CBO's long-term debt projections clearly show that current fiscal policies are unsustainable. In one scenario, the liftoff point for federal debt – that is, the time when debt starts rising without any sign of stabilizing – occurs shortly after 2020. By 2035, federal debt held by the public reaches 80 percent of GDP – a level only exceeded during and just after World War II. In another, more pessimistic scenario, the liftoff in debt has already begun, with federal debt held by the public reaching 181 percent of GDP in 2035, easily exceeding the peak debt to GDP ratio of 113 percent that occurred at the end of World War II.

A key part of the problem stems from rapid growth in entitlement spending, including spending on Social Security and, especially, Medicare. Over the next 30 years, the Government Accountability Office (GAO) estimates that the present value of future expenditures on all social insurance programs exceeds future revenue by over $50 trillion. That is nearly four times the size of GDP and clearly unsustainable.

Adding to my concerns for the nation's economic prospects is the current level of private indebtedness. As with government debt in the United States, private nonfinancial debt has grown steadily over the post-World War II period, from 40 percent of GDP in 1945 to almost 175 percent in 2009. Every consumer and business that is a net borrower would benefit from lower interest rates. And just as noteworthy, it should not escape our notice that rising inflation would trim the real value of their indebtedness. Thus, high private indebtedness will contribute to the political pressure on the Federal Reserve.

Three paths forward

Returning to my opening comments, I see just three ways forward in dealing with our current and prospective fiscal imbalances. While each involves considerable pain only the third will resolve the imbalances without eventually causing inflation to accelerate or precipitating a financial and economic crisis.

Monetize. One option for dealing with a fiscal imbalance is for the central bank to succumb to political pressure and monetize the debt. As deficits and debt levels within a country rise relative to national income, interest rates tend to rise as well. In this instance the central bank is often pressured to keep rates low and encouraged or required to assist the markets in facilitating the government's funding needs. If the central bank succumbs to this pressure, its balance sheet will expand, bank reserves will grow, and inevitably the money supply will increase. This process often appears benign at first, but if it goes on unchecked, the outcome is almost always higher levels of inflation and ultimately a loss of confidence in the value of the currency and the economy. Walter Bagehot's famous dictum about banks holds equally true for governments – once their soundness is questioned, it is too late. At that moment, governments and their citizens are forced to make sizeable, painful fiscal adjustments. An example of both the political pressure that can be exerted on the central bank, as well as the inflationary consequences of debt monetization is currently playing out in Argentina. The president of Argentina recently forced out the Governor of the Central Bank because he would not transfer reserves held at the central bank to repay Argentinean debt. Inflation in Argentina is currently running near 8 percent and will almost certainly increase.

Policy Stalemate. The second path forward is a stalemate between the fiscal and monetary authorities. In such a stalemate, the fiscal imbalance grows while an independent central bank maintains its focus on long-run price stability. Although the U.S. government is currently privileged to borrow at favorable rates, the fiscal outlook would inevitably undermine this privilege and its risk premium on debt would increase. Also, as the government competes with private borrowers for funds, the potential exists for the fiscal imbalance to drive up the real cost of borrowing and capital to the private sector as well. Eventually, this combination of large debt, and high cost of borrowing and capital weakens economic growth and undermines confidence in the economy's long run potential. Slowly, but inevitably, if the fiscal debt goes unaddressed, the currency weakens, as does access to global financial markets. And the cycle worsens, leading ultimately to a financial and economic crisis.

An interesting example in this respect is Canada in the first half of the 1990s. During this period, Canadian federal debt increased from about 55 percent of GDP to roughly 70 percent. At the same time, following a joint agreement between the government and the Bank of Canada, the Bank targeted a steady downward path for inflation from 3 percent at the end of 1992 to 2 percent at the end of 1995. With no monetary accommodation from the central bank, unsustainable government deficits and debt caused real interest rates in Canada to climb. While Canadian inflation was below that of the United States throughout this period, Canadians paid a substantial risk premium over U.S. rates to borrow. Moreover, the Canadian dollar came under persistent pressure. Overall economic performance suffered, with GDP growing very sluggishly in the recovery from the 1990–91 recession and unemployment climbing as high as 12 percent.

These economic conditions contributed to the election of a new government, which made a credible commitment to balance the budget. In the following years, the federal budget deficit fell dramatically. Revenue increased, and government expenditures were cut sharply. By 1996, Canadian interest rates had fallen below comparable U.S. rates. Inflation remained subdued, real GDP growth picked up, and unemployment fell.

Equitable Fiscal Discipline. The Canadian experience in the second half of the 1990s is suggestive of the third – and the only responsible – way to resolve our growing fiscal imbalance: By addressing its source in an environment of price stability. All seem to agree this is the way we would prefer to go, but of course the devil is in the details. At the outset, it requires an institutional framework committed to having an independent central bank. This discourages the fiscal authority from turning to its central bank and should it do so, strengthens the bank's ability to say "no."

In the United States, the Federal Reserve's policies in the early 1980s provide a vivid example of the benefits that arise from the exercise of central bank independence. During this time, high interest rate policies designed to lower inflation were deeply unpopular both among elected leaders and the broad public. But the Federal Reserve was able to exercise its independence and pursue long-term goals which systematically reduced inflation and changed the psychology of the nation regarding its expectation about inflation's path. As a result, the United States has had nearly three decades of low inflation.

Knowing inflation is not an acceptable alternative to strong fiscal management, a government faced with rising debt levels must provide a credible long-term plan to reestablish fiscal balance. The plan must be clear, have the force of law and its progress measureable so as to reassure markets and the public that the country has the will and ability to repay its debts in a stable currency.

To be broadly accepted, the plan must be seen as fair, in which there is a sense of shared sacrifice across all segments of the economy. Without being specific, these requirements suggest an approach in which we are willing to disappoint a host of special interests. It means, for example, controlling budget earmarks, trimming subsidies to numerous economic sectors, and resolving our banking problems and the perception that Wall Street is favored over Main Street, all of which would otherwise foster mistrust and cynicism among the public. Leaving these issues unaddressed will undermine the essential popular support required for the tough decisions needed to bring our federal budget into balance.

Finally, there are no short-cuts. We currently must adjust from a misallocation of resources. There is no way to avoid some short-term pain in fixing the fundamentals in our economy. It is inconvenient for the election cycle, and it is undeniably terrible to have at least 10 percent of the labor force out of work. But short cuts now mean people out of work again in only a few years because we again try and avoid difficult adjustments. Outlining a credible course for managing our debt for the future will accelerate the restoration of confidence in our economy and contribute importantly to sustainable capital investment and job growth.

Conclusion

As I mentioned in the beginning, the fiscal projections for the United States are so stunning that, one way or another, reform will occur. Fiscal policy is on an unsustainable course. The U.S. government must make adjustments in its spending and tax programs. It is that simple. If pre-emptive corrective action is not taken regarding the fiscal outlook, then the United States risks precipitating its own next crisis.

Eventually, government budgets that are severely out of balance are inevitably reformed – either by force of the markets or, preferably, by choice. Unfortunately, nations often must experience a profound crisis to focus the government's attention on taking corrective action. Usually it is at this point that governments reestablish fiscal discipline and renew their commitment to an independent central bank. Ironically, however, these generally are precisely the reforms that would have prevented a crisis in the first place. The only difference between countries that experience a fiscal crisis and those that don't is the foresight to take corrective action *before* circumstance and markets harshly impose it upon them. In time, significant and permanent fiscal reforms must occur in the United States. I much prefer this be done well before anyone feels an irresistible impulse to knock on this central bank's door.