1-1-2009

The Fed’s Binge

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Recommended Citation

Jeffrey Rogers HUMMEL. "The Fed’s Binge" *Reason* (2009): 52-53.

more government programs, a cleaner environment) than could be met.

When Ronald Reagan won in a near landslide—50.7 percent of the popular vote against Carter's 41 percent—inflation was the dominating concern. Voters didn't know that Reagan could control it; but they did know that Carter couldn't. Later, Carter himself judged that inflation had been the decisive issue against him, more important than his mishandling of the Iranian hostage crisis. Exit polls showed that 47 percent of Reagan's voters rated "controlling inflation" as the most important issue, followed closely by 45 percent who valued "strengthening America's position in the world." In the Gallup Poll in September, 58 percent rated inflation as the No. 1 problem.

How Inflation Was Subdued

The subjugation of inflation was principally the accomplishment of two men: Paul Volcker and Ronald Reagan. If either had been absent, the story would have unfolded differently and, from our present perspective, less favorably. Reagan, president from 1981 to 1989, and Volcker, chairman of the Federal Reserve Board from 1979 to 1987, forged an accidental alliance that was largely unspoken, impersonal, and misunderstood. There was no particular personal chemistry between the men. Nor was there any explicit bargain—you do this, and I'll do that. Although Reagan supported Volcker, many officials in his administration openly criticized him. Even while the alliance flourished, it sometimes seemed a mirage.

But the alliance was genuine, a compact of conviction. Both men believed that high inflation was shredding the fabric of the economy and of American society. The country could not thrive if it persisted. Buttressed by these beliefs, they broke with the past. Each had a role to play, and each played it somewhat independently of the other.

Volcker took a sledgehammer to inflationary expectations. He raised interest rates, tightened credit, and triggered the most punishing

The Fed's Binge

How the Federal Reserve engineered the most dramatic peacetime experiment in monetary and fiscal stimulus in U.S. history without anyone noticing

Jeffrey Rogers Hummel

UP UNTIL SEPTEMBER, Federal Reserve Chairman Ben Bernanke effectively sterilized all his financial crisis-fueled monetary injections, either by directly trading Treasury bills for riskier financial securities or by indirectly loaning to financial institutions with money recouped by selling Fed-held Treasuries on the open market. Either way, there was no major impact on the monetary base. As a result, the annual rate of growth of the monetary base remained in the neighborhood of 2 percent through August, with total bank reserves remaining virtually constant.

But after September 17, when the interest on T-bills briefly went negative, Bernanke opened the monetary floodgates. In August the monetary base had been $847 billion, with total reserves constituting $72 billion of that. (None of these figures are seasonally adjusted or adjusted for changes in reserve requirements.) A Fed press release on October 22 put the base at $1.149 trillion, a shocking 40 percent jump over the previous year. What has exploded even more is total bank reserves, where the base increase is concentrated. Reserves increased by an astonishing factor of five over the course of just one month, and as of late October were somewhere between $343 and $358 billion.

And that's not all. Federal Reserve Bank credit also doubled to around $1.8 trillion. Although Fed credit once closely mirrored the monetary base, that is true no longer—not since the Fed activated its U.S. Treasury supplementary financing account in the fall. This boosted additional Treasury deposits from zero to approximately $560 billion. The new deposits resulted from what the Treasury calls its Supplementary Financing Program, initiated in September to try to staunch the growing demand for Treasury securities manifested in falling T-bill rates.

Essentially, the Treasury is now issuing extra securities to borrow money from the economy, then loaning the money to the Fed in these special deposits so that Bernanke can re-inject it to make his bailout purchases of various securities, all without increasing the monetary base. In other words, what the infamous bailout act permitted the Treasury to do directly is something it had already started doing indirectly through the Fed to the tune of half a trillion. All in the name of easing a tight Treasury market.

This means that the total bailout is not the $700 billion that Congress appropriated, but at least $1.2 trillion. And that figure doesn't include the Fed's mid-October promise of $540 billion to bail out money market funds, which if not covered by the Fed's sale of other assets, will require either further monetary increases or further Treasury borrow-economic slump since the 1930s. In December 1980, banks' "prime rate" (the loan rate for the worthiest business borrowers) hit a record 21.5 percent. Mortgage and bond rates rose in concert. By the summer of 1981, consumers had trouble borrowing for homes and cars. Many companies couldn't borrow for new investment. Industrial production dropped 12 percent from mid-1981 until late 1982. In many industries, declines were steeper. In autos, it was 34 percent (from June 1981 to January 1982), and in steel it was 56 percent (from August 1981 to December 1982). By 1982 the number of business failures had tripled from 1979. Construction starts of new homes in 1982 were 40 percent below the 1979 level. Worse, unemployment exploded. By late 1982, it was 10.8 percent, which remains a post-World War II record.

It is doubtful that, aside from Reagan, any other potential president would have let the Fed proceed unchallenged. Certainly Carter wouldn't have, had he been re-elected, nor would his chief Democratic rival, Sen. Edward M. Kennedy (D-Mass.). Both would have faced intense pressures from the party's faithful, led by unionized workers—especially auto- and steelworkers—who were big victims of Volcker's austerity. Nor is it likely that any of the major Republican presidential contenders in 1980 would have acquiesced, including George H.W. Bush, Howard Baker, and John Connally. Reagan's initial economic program promised to reduce the money supply to curb inflation. He was the first president to make that part of his agenda, and he never retreated from it. As the economy deteriorated, he kept quiet. He refused to criticize Volcker publicly, to urge a lowering of interest rates, or to work behind the scenes to bring that about.

When the president did speak, he supported Volcker. At a press conference on February 18, 1982—with unemployment near 9 percent—Reagan called inflation "our No. 1 enemy" and referred to fears that "the Federal Reserve Board will revert to the inflationary monetary policies of the past." The president pledged that this wouldn't happen. "I have met with Chairman Volcker several times during

ing. Thus we now have the worst of both worlds: a massive bailout financed both by Treasury borrowing (in order to avoid inflation) and a Federal Reserve increase of the monetary base (which heralds future inflation anyway).

Of the $1.2 trillion increase in federal government borrowing, at least half took place within the space of a month. This sudden 25 percent increase in the outstanding national debt qualifies as the most dramatic peacetime experiment in fiscal stimulus the U.S. government has ever implemented. If Keynesian theory were correct, the economy should have been well beyond the reach of any potential recession by the end of October. But how many economists are going to acknowledge this striking empirical refutation of the fiscal policy they hold dear?

This enormous increase in government debt may at least partly explain the sudden stock market collapse after the bailout passed. Government borrowing represents a future tax liability, and expected future taxes affect the value of equities. Some argue that this new borrowing may not increase taxes at all because it merely finances the purchase of earning assets that the government can later resell. While that's certainly possible in the long run, no one knows the true value of those assets in the short run. After all, the market's anxiety about their worth was the justification for the bailout in the first place. So now the government is transferring that uncertainty from private financial institutions to the taxpayers.

Meanwhile, there will be a lag before the broader measures of the money supply feel the effects of the Fed's money bomb. The year-to-year annual growth rate of M1—currency in circulation plus checking accounts—had already risen from 0 percent to over 7 percent as of late October, whereas that of M2 (M1 money plus other types of deposits and most money market funds) is up slightly from 6 to 7 percent. But as centuries of experience has shown, an increasing money supply will inexorably lead to increasing inflation.

Bernanke is betting that he can reverse the process before inflation gets out of hand. But that will require the Fed dumping billions worth of securities it has recently purchased back on the market. It is anybody's guess when Bernanke will judge that the financial system is sound enough for him to do so. All the emergency initiatives of both the Fed and the Treasury since the subprime problem first emerged have not merely proved stellar and consistent failures. As Anna Schwartz, Milton Friedman's esteemed co-author, and other economists have suggested, the thrashing about of Fed and Treasury policy has undoubtedly made the financial situation worse. The prospects do not look promising. ◘

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