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POLICY WATCH SECTION

Monetary morphs into fiscal: the Fed's great adventure

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Abstract

This paper focuses on some oft-neglected effects of the post 2008 US monetary policy and the revised way of estimating inflation by the Bureau of Labor Statistics. The Quantitative Easing monetary policy since the Lehman crisis in fact carries the implication of a fiscal measure in the form of a shadow tax. The effect of this shadow tax can be exacerbated by any under-biased inflation data. These factors can help explain why such monetary measures have not brought growth to the real sector and why the economic recovery has been weak.

Keywords: Quantitative easing, stimulus, monetary, fiscal
JEL Classification Codes: E5, E6, H3, N1

Introduction

Post 2008, Quantitative Easing (QE) is central to US economic policy. The expectation, or ostensible hope, was that injections of money stimulate economic recovery and growth in the real sector. Seven years later, the economy continues to languish. Monetary measures failed to bring recovery to the real sector. It has generally escaped notice that QE has had the effect of a tax increase on savers, retirees, and those with fixed or inelastic wages. Absent prospects for profitable investment in plant and equipment, industry will not invest even with historically low interest rates. Low interest rates alone have not motivated sufficient spending to bring economic growth.

This paper examines the effects of QE on the economy, and how it has moved beyond monetary policy, merging into fiscal effects. This has been enabled by the methods by which inflation is calculated now in the US that understate the experience of consumers and conceal the negative real interest return that savers and investors earn. Lack of hyperinflation that would normally be expected when a nation's money supply increases greatly is also examined.

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Finally, strategies that may allow an orderly exit from QE are discussed.

Quantitative easing

In the minds of many there is a wall between monetary and fiscal policy. In macroeconomics classes students learn that monetary matters involve money and interest rates. Fiscal matters involve spending and taxes. The Federal Reserve (Fed) controls money, the amount of it in circulation and influences or controls interest rates. The Fed is not part of government, it is a private institution owned by its member banks. But it works as a partner with the Treasury to implement government policy.

In the post 2008 era, we witness a unique environment in the US and much of the developed world. In it we see the result of the Fed's actions is tantamount to imposing a stealth tax on fixed income investors, those on cost-of-living contracts, and retirees.

The Fed, in its Quantitative Easing (QE) programs, has forced nominal interest rates[1] to near zero.[2] The Federal Government, through its Bureau of Labor Statistics, reports inflation to be at such a low level that consumers know it does not reflect their experience. Using the BLS method of calculation that was in place in 1980 the Consumer Price Index for Urban consumers (CPI-U) reported for November, 2014 is 9 percent. But the official CPI-U was reported by the BLS as only 1.3 percent. How can this be? It is largely due to the BLS adjusting the index for what some creative economists call “hedonic” factors: things such as bigger TV screens, cheaper electronic gadgets; i.e., getting bigger and better things for the same money. Many of these are items that consumers do not buy often. But they do buy ground beef, gasoline, medical services, and so on frequently. To some, adjustment for hedonic factors might seem arbitrary and capricious, perhaps reminiscent of Gulliver's Grand Academy of Laputa.

Instead of dwelling on the issue of price index measurement, let us stipulate that officially reported CPI-U understates the every day experience of most consumers, and go on. And let us stipulate that the United States in involved in a great many military operations that are extremely expensive irrespective of whether or not they are necessary or desirable. Those operations must be paid for somehow.

In the modern world plunder and tribute are not in fashion. Thus there are only two ways to pay for those military operations. The US government can pay for wars and occupations, foreign aid, et cetera, with taxes or else with borrowed money. Today the cost is far more than taxes can cover. Raising taxes would put the cost of those operations in the public spotlight and spawn popular protest. Thus the alternative of borrowed money must be used.

Today most of the government's borrowed money comes from the Federal Reserve. When Treasury needs money the Fed credits the Treasury account for X billions of dollars. Where does the Fed get the money? By the magic of a few computer keystrokes. The Fed gets interest payments on that money. It costs the Fed nothing, but it collects interest, an incredible money machine. The Fed is fixing interest rates at historically low levels. Some may say, “that's good, it saves taxpayers money.” But it ignores that only those debtors who borrow at the low rates benefit, investors and savers do not.

1 The nominal rate is composed of two major items, a real rate of return, and a rate of inflation. A priori the rate of inflation is not known but the expected rate. Ex post the real rate depends on the realized rate of inflation.

2 This creates an analog to Keynes' liquidity trap, a reserve trap. See Herbst et al. (2014).

Interest rates

The real interest rate, stripped of the amount investors would normally demand to compensate them for inflation, is now negative by any honest measure of inflation. That means that savers lose money by keeping it in saving accounts. They are guaranteed losses in purchasing power. This is tantamount to taxing their wealth. But unlike an increase in income or other direct taxes, most people do not pin it on any particular culprit. The blame for it is diffused. Inexorably, it takes saver and investor wealth away incrementally over time. For those who are fortunate to have saving, a negative real rate guarantees it will lose value. They will lose purchasing power. Buying a house is at best a dream for many young persons in debt and unable to find employment that allows saving. For retirees, living out one's remaining years in comfort and dignity becomes impossible.

That seems unfair, so some urge raising interest rates. But consider that with US Federal debt now above $18 trillion, even a one percent across the board increase in interest for the US Treasury would be $180 billion per annum. Based on historical perspective, a plausible and reasonable increase in real rates would be 3 or 4 percent. It might be even more if the 1980 or 1990 CPI calculation were to be used. Either taxes would have to be increased, or else the Fed would have to create still more dollars. Eventually this would lead to hyperinflation even if it does not happen immediately. It would accelerate as foreign holders of US dollars increase selling them. The dollar at some point would lose its status as the world's reserve currency when the mountain of offshore dollars comes home. There is some indication that nations are already gradually reducing their dollars. An unknown at this time is whether, or when, it will accelerate to dumping and to surging inflation. Those who say “Never!” are referred to the currency statistics for Weimar Germany in the months before their hyperinflation. It happened quickly once the trigger point was reached in 1923, as the currency supply exploded.

Keynes advocated increasing government spending to stimulate a depressed economy into recovery. He did not recommend a monetary policy stimulus, lower interest rates. He warned of a liquidity trap, when interest rates were too low. The phrase for monetary policy “You can't push on a string!” was widely held as true. However, in 2008 that changed for US economic policy. The Fed embarked on a virtually unchallenged adventure into a de facto fiscal *terra incognita*. It began manipulating interest rates in a way that imposes a shadow tax on savers and investors. Some might say that is not a tax. But anything that takes money or purchasing power from those who own debt securities or have saving accounts is a tax whether called that or not.

This morphing of the Fed into a fiscal agent can be critically examined in light of traditional Keynesian theory. The Fed is imposing a *de facto* tax on saving and investing, depleting the wealth of the middle class, and most especially retirees. It is not stimulating consumer and industry spending as a tax cut would, or as government spending that finds its way into consumer budgets would. What it is doing is increasing US debt to levels inconceivable prior to 2008.

Eventually a question that must be asked is “Should this be reversed? If so, how?” Can the Fed return to a role that is entirely monetary? Will Congress act to clarify the role of the Fed vis-à-vis the Federal government? History written a decade from now will provide interesting reading.

Qui Bono?

The Roman question, *Qui Bono*?, “To whose benefit?”, should be asked today about QE. But US mainstream media avoid demanding an answer to that. In 2007 US Treasury Secretary

Hank Paulson claimed the major banks had to be bailed out of the financial mess in the US financial system. The Fed and US Treasury meekly complied, with scarcely a murmur of complaint from the media or Congress. There was little demand for accountability by those responsible for the existential threat to the economy. There still is not.

"Too big to fail banks" grew even larger. Few alarms were sounded by mainstream media. The dozen largest US banks were not only bailed out, they grew significantly larger. Perhaps more important, their political influence grew. Who in Congress can now dare oppose them? In late 2014 Congress modified pending legislation to provide taxpayer guaranty of bank losses that might be incurred speculating in derivatives. It was signed into law on December 16, 2014. Few in Washington stood against it. US media took little notice, and voiced even less complaint. The financial giants stand to gain mightily from it (Brown, 2014). Only a few weeks later the failures began from oil derivatives, albeit with a large UK bank, Standard Chartered (Zero Hedge, 2015).

Where are the public voices one might expect, demanding to know who profited from the losses incurred by the banks that were bailed out in 2008? The US media reported the losses, but did not discuss the other side of that, the profits. It would be interesting to examine whatever culpability the profit takers might bear for the potential economic collapse.

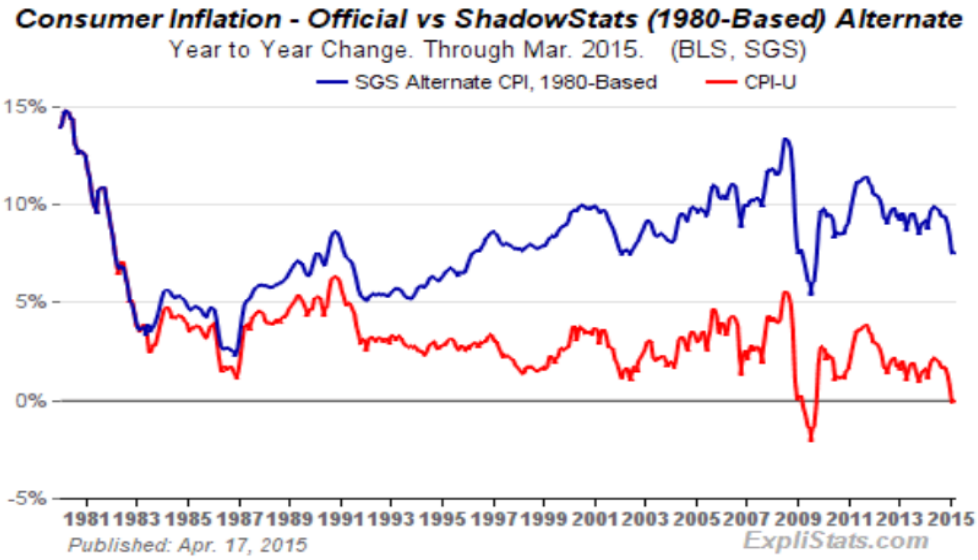
Some might say "QE to infinity" is a conspiracy to wipe out the US middle class. That imputes intelligence, planning and malice, is harsh and unproven. But the US middle class continues to shrink. Savers and retirees continue to lose wealth. Many college students are deeply in debt for their educations while struggling to find employment that enables them to pay off those debts. The unemployment rate may be much higher than what is reported by an uncritical media, according to those who look beyond official numbers. Worse yet for those on fixed incomes, retirees living on social security, those in the military, many of those on union contracts with cost-of-living-adjustment clauses, those with private pensions, and savers, the Bureau of Labor Statistics reports a consumer price index, a CPI-U, that seriously understates inflation.

What a difference it makes

The following figure shows inflation measured by the current Bureau of Labor Statistics method with the method used in 1980. The BLS method of 1990, not shown, displays a somewhat lower rate than that for 1980 but still much higher than the current BLS method. The difference between the red line and the blue line is tantamount to a shadow tax on those with fixed incomes, and savers. It is income they lose because there is inadequate adjustment to their incomes, little pressure to raise social security payments to compensate for inflation, or to raise military pay, etc. Why raise these when the government reports that inflation is only about two percent? But there is more to it than that.

Nominal interest rates normally are determined by supply and demand. Long term and intermediate term federal government interest from 1925 to 2004 averaged a real (i.e., net of inflation) rate of return of 2.3 percent. Inflation over the same span averaged 3.1 percent (Ibbotson Associates). Together they combine to make a nominal rate of 5.4 percent. So even if inflation were truly only about 2 percent, as now reported, the nominal interest rate on savings today should be at least 5.1 percent if the real rate were at the long-term average. But one cannot safely earn that much interest today. Those who save now lose. If savers earn less than one percent, while inflation is officially two percent, they lose. If one recognizes that inflation is really 10 percent and the most he can earn in interest is about 3 percent on 10-year US Treasury bonds, the loss is 7 percent per annum in purchasing power, pre-tax. That is reduced by income tax on the nominal gain. Most savers do not directly buy Treasury bonds, though their pension funds may. Some still save in passbook accounts or buy certificates of deposit that now yield much less than one percent per annum. Thus they lose over 9 percent per year. In just 8 years at that rate they lose half the purchasing power of their savings, more than that when adjusted for income tax.

Figure 1. Comparison of inflation measures



Source: ShadowStats.com

Where is the hyperinflation?

A chorus of voices since the advent of QE has predicted hyperinflation. Where is it? German Weimar inflation of 1921-23 might suggest a plausible reason it has not appeared. Climax came in 1923 when German currency supply exploded, and its value collapsed. Many historians believe that the armistice imposed on Germany after World War I necessitated the debasement of the currency in order to force German citizens to cut consumption in order to pay reparations. German bond investors and savers were wiped out. Borrowers gained relief; their debts could be repaid with worthless currency. Imported goods became impossibly expensive, consumers had to forego them. German goods became cheaper in foreign currencies, stimulating export sales and earning foreign exchange to pay reparations.

The US dollar became the world's main reserve currency after World War II. Today that role is being questioned. Tensions with Russia, continuing conflict in the Middle East, and distrust of the US after revelations about NSA spying, may overcome inertia about changing the dollar's status. If Germany joins the BRICS nations, the dollar may lose standing as reserve currency. Then, if France joins, and is followed by other western nations, the dollar likely will quickly fall as reserve currency. If that happens, the Cassandras predicting US hyperinflation may at last be vindicated.

If there is one certainty in all this that most would agree with, it may be that the world financial system is not in, or near, a stable equilibrium. The question this prompts is “How can it move to a new, at least semi-stable, equilibrium?” And “What will the new equilibrium look like?”

Exit strategy

What would happen if interest rates were set by the market, instead of the Fed and Treasury? What would happen to the federal government's budget deficit? The US federal government now runs a historically high deficit, spending far more than it finances with tax revenue. If interest rates on US Treasury securities were to double, triple, or surge even higher, what would happen? Never mind "too big to fail." The US government is far larger than the largest dozen or so banks. What would happen to the value of the US dollar in terms of foreign currencies, gold, silver, platinum, and other tangible assets? Could it be a rerun of the Weimar days in 1923 Germany? No one knows. But the possible scenarios are worrisome.
As legendary bond trader Bill Gross put it in December, 2014:

> "In fact, in the U.S., as elsewhere, there has been little focus on public investment and infrastructure spending. It's been all monetary policy, all of the time, with most of the positives flowing over to markets as opposed to the real economy. The debt currently being created is not promoting real growth and solving a debt crisis – it is being used by corporations to repurchase shares and accentuate the growing inequality between the very rich and the middle class." (Gross, 2014).

In late April, 2015 Hilsenrath and Sparshott writing in the *Wall Street Journal e*xpressed doubt about exiting from QE, a doubt widely shared:

> "The nation's central bank pointed to cooling economic activity and reduced job-market gains in its policy statement Wednesday, underscoring uncertainty among officials about when the economy will rebound and clouding the timing of when they will begin to raise interest rates. Earlier in 2015, many officials thought a midyear rate increase was possible. Now it looks highly unlikely." (Hilsenrath and Sparshott, 2015).

The Fed and Treasury have no good choices for an exit strategy from QE. At best they face a tri-lemma, three dubious choices. One is to simply raise interest rates in one stroke. A second is to continue doing nothing, to continue QE indefinitely. A third is to commit to gradually raising interest rates.

Raising Rates in One Step could bring chaos to the economy. The US Treasury already has a huge budget deficit at the current extremely low level of interest. Raising the rates paid by Treasury by even one percent would increase the deficit significantly. Investors that own bonds would suffer losses. They would either take capital losses or be locked into the bonds, perhaps to maturity. That would repeat the lock-in of post World War II faced by banks and other bond investors.

Investment in the real economy requiring issuance of new debt would be discouraged. In an economy continuing to struggle, no one will want to be associated with the decision behind it.

Without more borrowing to cover it, the federal government would have to finance the increase in interest it pays. In a languishing economy tax increases would be anathema. So there would have to be serious curtailment in spending, perhaps significantly reducing US overseas military involvement. Or, once again, the Fed would create still more money to buy new, higher nominal yield debt from Treasury. Where this would end no one can know with confidence.

Continue QE Indefinitely and hope that things will resolve themselves in due course might appeal to those running the Fed and Treasury today. Such inertia is analogous to one suffering a toothache delaying a visit to a dentist. There will be increasing discomfort and pain until the problem must be fixed. If one were making predictions however, this might be the safe forecast of what the Fed will do.

Gradually Raising Rates might work, if and only if it was set up right in the beginning. If it were set up with slack to allow constant tinkering the markets would lack confidence in the plan. But if it were set up so that interest rates increase by, for example, 10 or 20 basis points per month or quarter until a long term normal of about 2 to 3 percent real return were reached, it could work. The rate of increase might be tapered off as the target was closely approached.

Conclusion

We have not considered radical solutions to a possible exit from QE. Such solutions, while not impossible, are quite improbable. Among them are such things as replacement of the current US dollar with a new currency, perhaps one again backed by a commodity like gold, silver, a particular grade of crude oil, or a crypto currency like Bitcoin. Another, such as replacing existing fixed income securities at parity, one-for -one with new securities having identical maturity, payment dates, and principal amounts, but with higher interest rates. Still another might be to provide a tax credit to those who would incur capital losses on bond investments. To avoid endless wrangling in Congress, and speculation that would roil markets, any such move would need to be done in secret until it was launched. That is extremely unlikely in the current climate in Washington and other democratic nations. Partisan politics would have to be put aside to develop and implement a workable plan.

Higher interest rates coupled with Fed money creation suggests that some adjustment to the interest paid to the Fed could be made. Considering that the cost of creating Fed money to buy Treasury debt is virtually nil, one may argue that the Treasury and citizenry should not have to pay for that, at least not in such economically stressed and perilous times.

Clearly the Fed and Treasury have a Herculean task before them. None of the choices before them are desirable. But the “do nothing choice” might be the worst since it risks continuing and deepening the malaise of the US and world economies. Raising rates risks a very painful downward plunge in bond prices. However, that might bring a catharsis that could be healthy for a true and steady recovery. The Fed has no unambiguously good solution to an exit from QE. Any feasible plan will require agreement between the branches of government to support a plan, one that will be allowed to work without constant nit picking and modification that will only fuel uncertainty.

A full recovery from the current economic malaise will require more business friendly policies to encourage risk taking as a precondition for the real sector to invest. Currently there seems to be risk aversion, perhaps exacerbated by a lack of clarity on economic policy. The maxim that risk and reward go together does not hold up well to scrutiny today: There is ample risk, with scant reward in many cases. A reserve trap, relying on exchange rate management and favorable trade to grow out of the recession needs to be exited.

Somewhere in the mix of measures that will allow an orderly end to QE there needs to be a discussion of government spending. Higher interest rates will raise the US government's budget deficit. There must be either large tax increases, poison to a languishing economy, or else curtailment of spending. Whether there is a will to do so is implausible given the military-industrial complex US president Eisenhower warned about, and the sensitive issues involved in unwinding overseas engagements. If spending cannot be curtailed, then further monetization of the debt will be the only way to fund the government deficit.

A key requirement to an orderly exit from QE is firm political commitment to an equitable plan. The economic record following 2007-2008 does not inspire confidence. An equitable plan will share benefits and costs fairly across the income and wealth spectrum. This will be difficult to achieve. If disproportionate political power continues to be held by the wealthiest one-percent it might be impossible. The broad public has seen that the financial institutions responsible for the conditions leading to the economic crisis of 2007-8 were bailed out with few losses beyond Lehman. The US media make little mention of that, but a recurrence as QE is exited might lead to talk of mobs with "pitchforks and torches" marching on New York and Washington.

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