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Teaching about Money and the Fed

Too Low? For Too Long?

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This article represents the fourth in a "ghost story" series by the same authors. Readers may recall that then-Federal Reserve Chair Ben Bernanke was "visited" by the ghosts of Adam Smith and John Maynard Keynes (Social Education, *March/April 2010) as these two noted economists debated the economic recovery. Bernanke was visited again by the ghost of Keynes and this time also by the ghost of Milton Friedman* (Social Education, *March/April 2012), who discussed the then new quantitative easing policy of the Fed. In the March/April issue of 2013, Bernanke was visited once more by both Keynes and Friedman. This time, inflation at various times in world history was the debate topic. In the new ghost story that follows, Janet Yellen is visited by two renowned and opposing economists—John Kenneth Galbraith and Friedrich A. Hayek—for a discussion regarding the direction of today's monetary policy.*

The Great Recession Is Followed by the Great Debate

The debate over monetary policy following the Great Recession, which began late in 2007 and ended in 2009, will no doubt continue for years. To many economists, it appears that Ben S. Bernanke was the right person at the right time to handle the crisis. As chair of the Federal Reserve Board of Governors in Washington, D.C., he led the Federal Open Market Operations Committee (FOMC) in using the Fed's bond purchasing ability to increase the money supply and, thus, drive down the Federal Funds Rate (the overnight lending rate of banks) to near zero. Since other rates follow the Federal Funds Rate, he was able to move interest rates—like the rate on home mortgages—to historic lows.[1]

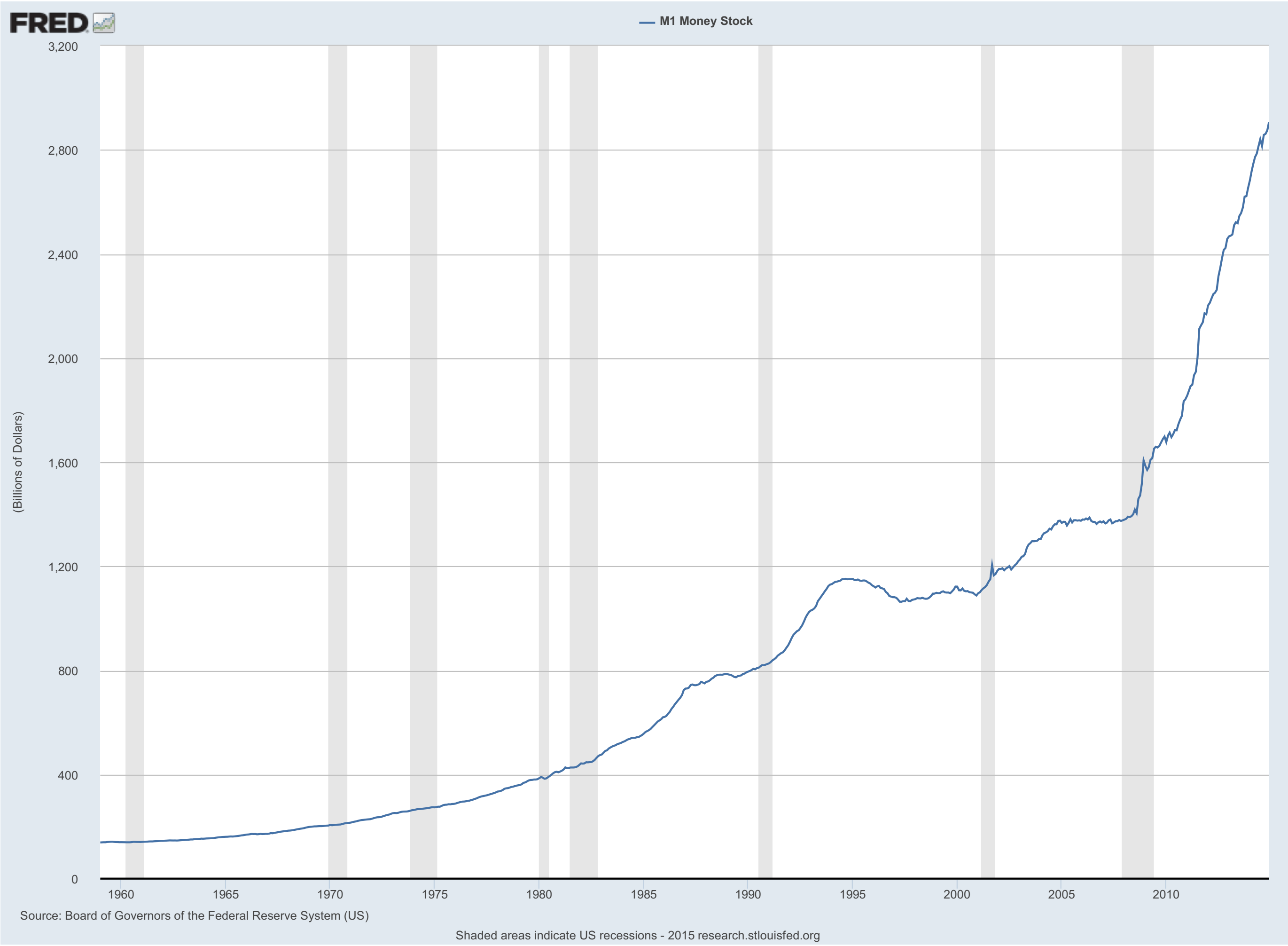
Bernanke also moved aggressively to make sure the Fed fulfilled its role as the "lender of last resort." In 2007, the housing bubble had burst. It was accompanied by a stock market collapse. The Fed acted swiftly and decisively to make sure the United States did not face a contagion of bank closings of the sort that were the major cause of the Great Depression of the 1930s. Bernanke, a scholar who had written widely about the financial collapse of the 1930s, was not about to repeat that mistake of the past. American banks and some other financial institutions had plenty of cash in the form of credit from the Fed to remain solvent as the crisis hit a peak and finally faded.

Today, there is evidence that the actions he took were right on the mark. Unemployment stands at 5.5 percent, down from a crisis high of 10.1 percent. Stock prices have recovered completely and have now risen to record levels. The economy has been growing, albeit sluggishly, since 2009.

But no one seems pleased with the slow pace of the recovery. Although unemployment has come down from its high of 10 percent, it has not returned to pre-recession levels. The Fed faces a dual mandate from Congress: It is to (1) keep prices stable and (2) keep unemployment low. The Fed's primary tool to influence prices and unemployment is to focus on interest rates. As mentioned previously, the Fed had already driven rates to near zero by late 2008. Actions of a new sort would be necessary then if the Fed was to continue to act. Thus, the Fed launched its Quantitative Easing operation. This meant that the Fed would use new money to purchase additional U.S. government securities as well as mortgage-based securities from banks. The idea was to get still more money into the economy in an effort to keep other interest rates low so as to stimulate business and consumer spending. Quantitative Easing was followed aggressively. Today, the Fed holds about $2.4 trillion in federal debt.

How will it all turn out? No one knows for sure. Inflation "hawks" fear that the Fed has kept interest rates too low, for too long. Low interest rates have hurt savers—or anyone else hoping to earn a return from bond purchases—and provided an incentive to buy stocks, thus risking the creation of a new stock market bubble, not unlike the one we just experienced in the housing crisis of 2007. The most common measure of the money supply (what economists call M1. See Figure 1) has skyrocketed to over $2.8 trillion, up by about $1.3 trillion in 2007 before the Great Recession. Banks are keeping over $2.5 trillion in excess reserves—funds that are being held in their reserve accounts with the Fed—instead of being lent out to

Figure 1. **The U.S. M1 Money Supply**



consumers and businesses. The increase in the supply of money and the holdings of excess reserves by banks are unprecedented and thus are a persistent source of concern.

Inflation doves—including the Fed's new chair, Janet Yellen—are more sanguine regarding future inflation. They would like to see more evidence of a sustainable recovery before increasing interest rates. They fear that acting too soon would slow the expansion. The doves note that the slow rate of economic growth—GDP is expected to increase below 3 percent for the next three years—suggests that inflation will remain subdued. Further, they observe that the economy continues to operate below its potential, suggesting that inflation is not on the doorstep. And, of course, the Fed ended its bond-buying program in October of 2014. The stock markets took the discontinuation of the program in stride. Thus, the Fed is cautiously stepping back from its more aggressive policies. Eventually, it will need to begin to increase interest rates. No doubt, it will do so with equal caution. But, will it have acted too late to stave off a serious round of inflation?

The FOMC Meeting in June 16–17, 2015

For Yellen, the stress this time around was palpable. Tensions are always high in the period just prior to an FOMC meeting, but this meeting was unusually worrisome. The Fed had signaled in 2014 that sometime in 2015, it would begin to raise interest rates to more normal levels. The time for a clear decision was rapidly approaching.

The members of the FOMC usually respect the wishes of the chair. However, dissenting views were now expressed more emphatically. The FOMC inflation hawks were indicating that the Fed was dragging its feet. Fears of inflation were widespread. Yellen, ever the consensus builder, was troubled. She wanted the Fed to speak in one, confident voice.

Yellen had gone through her customary complete and exhausting routine before the two-day FOMC meeting, including staff meetings, briefings from distinguished economists and consultations with world leaders. On the night before the first day of the FOMC meeting, Yellen left her office a little early to have a light dinner with family and to turn in. Soon enough, she quietly drifted asleep.

Before long, she fell into a deep dream. In it, she wondered how other economists on the national and international stage would act in her circumstances. John Kenneth Galbraith came to mind. He was an intellectual powerhouse. He served presidents Franklin D. Roosevelt, Harry S. Truman, John F. Kennedy and Lyndon B. Johnson. He served as the U.S. Ambassador to India for the Kennedy administration and spent 50 years as a Harvard professor. He wrote popular books like *The Affluent Society* [2] and *The New Industrial State*.[3] Like Yellen, he was worried about strong corporate power, a hobbled public sector, and unemployment. Like her, he was confident that strong government actions—like raising the minimum wage—could make things better for the average citizen.

Unexpectedly, Yellen's thoughts shifted to a very different man—Friedrich August Hayek. Hayek was more or less the opposite of Galbraith. He never wrote a best-selling book nor was he a political insider. While his ideas were well known to Prime Minister Margaret Thatcher and President Ronald Reagan, he tended to remain in the background, writing books and articles that would eventually earn him the Nobel Prize in Economics in 1974. Unlike Galbraith and Yellen, Hayek was no Keynesian. Quite the opposite. He was the founder of the Austrian School of Economics—a reaction against Keynes. Well versed in monetary policy, he believed that policies to combat unemployment would inevitability lead to inflation. He knew a thing or two about inflation. He was working at a statistical research institute in Vienna in 1923—the period of hyperinflation for the Weimar Republic. He had 200 pay raises in eight months. Money was cheaper than wallpaper. Inflation wiped out the savings of the middle class and paved the way for the totalitarianism of Adolf Hitler's Nazis. Hayek always saw inflation as an evil that corroded society and undermined democracy.

FOMC Dreaming

Yellen's dream that night may have gone something like this:

Yellen: John Kenneth Galbraith, it is a pleasure to have a few moments to visit with you.

Galbraith: The pleasure is all mine—please call me "Ken." I have been an admirer of your work for many years.

Yellen: And is that Friedrich A. Hayek I see standing before me?

Hayek: It is. I am very pleased to be in the presence of such accomplished economists, even if it is only in a dream.

Yellen: Gentlemen, I am sure that you know that I am worried. We have successfully discontinued buying federal bonds and mortgage-backed securities that were the key component of our Quantitative Easing policy: Now I am facing pressure from several sources to begin to raise interest rates. But I am still worried that it is too soon to act. Unemployment has, indeed, headed in the right direction, but the recovery has never been strong. The President and Congress have done almost nothing by way of implementing pro-economic growth policies. So, it seems that the burden has fallen on the Fed to act alone. I fear that raising rates too soon could reverse direction and tip us into another recession.

Galbraith: First, allow me to compliment you and your predecessor, Ben Bernanke, for the splendid disaster control you did at the outset of the Great Recession of 2007. I did not live to see the crash, but I did see it coming—it was just like 1929 all over again, with many of the same mistakes that I documented in my 1955 book *The Great Crash, 1929*.[4] You and Ben had to clean up the mess when you were vice chair of the Fed's Board of Governors. When the Fed acted to supply banks and other financial institutions with all of the cash they needed to survive the collapse, it wasn't a "bailout," but rather a smart use of federal power to preserve institutions. You know how much importance I always placed on institutions in my writing and teaching. History will show you were right.

Yellen: Thanks for the kind words. Coming from someone as distinguished as you, they mean a lot. What is your "take"? Do you think the Fed should begin to increase rates?

Galbraith: No. I think inflation fears are overstated. It's time to keep your eye on the ball of stimulating the economy with low rates so consumers will continue to buy and businesses—especially housing—will continue to expand. Reducing unemployment to pre-recession levels should be first and foremost. As you suggest, if you don't act, no one else will. Plus, given the dual mandate, it is part of your job.

Yellen: But you know politicians will bash us in the media for being reckless if we keep rates low.

Galbraith: Yes, even more than in my day, now that you have Twitter and social media. But as I once wrote to President Kennedy, "Politics is not the art of the possible. It consists in choosing between the disastrous and the unpalatable."[5] It is unpalatable to endure media criticism for risking inflation—but it would be disastrous to raise rates too soon.

Hayek: My dear colleagues, are you prepared to entertain some disagreement regarding these matters?

Yellen: Of course. Welcome to the conversation. I remember reading with great interest *Prices and Production*, your classic book on money supply.[6] Every central banker I know has read it. What say you, Professor Hayek?

Hayek: I am concerned that the actions you and your predecessor, Mr. Bernanke, have taken have served to sow the seeds of future inflation. You have already waited too long to raise rates. The Fed tried to reduce unemployment by increasing the money supply by an unprecedented amount. Most of these funds sit unused in banks' reserve accounts. They are not being used to help consumers buy cars and homes and to expand businesses. Once these reserves begin to flow into the economy, inflation will certainly follow. We risk a return to the bad old days of the late 1970s when then-Fed Chair Paul Volcker courageously raised rates so high that he induced a deep and painful recession and wrung inflation out of the economy. This is what set the stage for the robust economic expansion of the Reagan and Clinton years. I fear that we have forgotten these lessons of the not-so-distant past.

Yellen: Friedrich, these are sobering thoughts. Do you have additional concerns?

Hayek: Yes. These artificially low rates provide incentives for people to invest in projects they otherwise would avoid if the market reflected the real cost of credit. This tends to induce the boom and bust cycles the Fed should be trying to avoid. With interest rates so low, for example, savers have invested heavily in the stock markets since returns on bonds are so low due to the Fed's interest rate policy. This flow of funds into the stock markets appears to be a new bubble caused by artificially low rates. When the bubble bursts, people's savings will be destroyed. My other concern is the national debt, which is now over $18 trillion. When interest rates increase, interest payments on the debt as a part of federal spending will soar. This will displace federal spending for all sorts of other important government functions from defense, to courts, to roads and to education. This is the unintended consequence of the Fed's Quantitative Easing.

Yellen: What do you think should be the main role of monetary policy today?

Hayek: The preferred action of the Fed should be to establish stable and predictable interest rates. It should resist manipulating rates up and down to offset the business cycle. If this were the policy, consumers and business people could stop guessing about interest rates and turn their attention to making sound decisions based on the real economy without worries about unexpected changes in rates.

Yellen: Ken, you have gone uncharacteristically quiet. What is your reaction to Friedrich?

Galbraith: I think we know a lot more about monetary policy today than we did when Friedrich first wrote about it. Let's look at the big picture. Inflation has been held in check for over 30 years. We experienced unprecedented economic growth during the Reagan and Clinton administrations due in no small part to the wisdom of my old friend Alan Greenspan, who was chair of the Federal Reserve Board of Governors over that period. In the future, the Fed needs to be eclectic—looking at a broad array of indicators the way Alan did, and not focusing on any one measure. There is a lot of slack in the economy now. That will keep inflation down, and I believe that with sufficient study and caution, the Fed will be able to unwind from the large supply of money it created in a time of emergency. I am confident that the Fed will be able to provide a smooth transition

as we return to normal times—keeping inflation and unemployment low.

Hayek: My distinguished colleagues, you have missed one of the most important points of all. The artificially low interest rates of recent years have enabled the president and Congress to go on a big spending binge. Additional government spending looked like a great bargain because the borrowed money to pay for it was so cheap. This has distorted the economy toward several unproductive projects, undertaken by government that would never be chosen by free people interacting through markets.

Galbraith: On the contrary, government spending is a great bargain when interest rates are so low. It brings the economy back toward full employment. And it allows us to correct what I called the "social balance"—the relationship between private and social spending, which I always thought was distorted away from social spending in favor of the free market's trinkets.

Hayek: There's a social balance, all right. But the relationship is the opposite of what you are saying. I think spending right now is tilted way in favor of government, which does (after all) have the ability to commandeer resources from the private sector.

Yellen: Gentlemen, I do appreciate your insights. However, I do not think you can settle this argument in just one dream.

Conclusion

Yellen awoke from her dream, reminded that she still had a decision to make. Should the Fed begin to reverse course and raise interest rates in an effort to return to a more normal economic environment? The decision would be reached over the next two days.

On the one hand, there is evidence that the Fed has been on the right course. Total employment has risen every month for more than four years. More than eight million jobs have been created since the lowest point of the Great Recession. Unemployment was down to 5.5 percent from its high of 10 percent at the beginning of the Great Recession. The Fed's governors have behaved in an activist manner that is consistent with their dual mandate of stable prices and high employment.

On the other hand, fear remains among some economists that the Fed's actions are a ticking time bomb. The stage has been set for a return to high inflation in the future, expanded levels of national debt due to interest rate increases, and the bursting of the stock market bubble. It's a wonder that Janet Yellen gets any sleep at all.

Notes

1. The Federal Open Market Committee (FOMC) is the group that makes monetary policy for the Federal Reserve System. It meets in Washington, D.C., eight times a year. The voting members of the FOMC are the members of the Fed's Board of Governors and the presidents of five Federal Reserve Banks, including the Federal Reserve Bank of New York. Most often, the FOMC formulates monetary policy by setting a target for the federal funds rate, the interest rate that banks charge one another for short-term loans. The Fed buys or sells bonds through the Federal Reserve Bank of New York in an effort to move the federal funds rate to the desired target.
2. John Kenneth Galbraith, *The Affluent Society, 40th Anniversary Edition* (Boston: Mariner/Houghton Mifflin, 1998).
3. Galbraith, *The New Industrial State* (Princeton, N.J.: Princeton University Press, 1967).
4. Galbraith, *The Great Crash, 1929* (Boston: Mariner Books: Houghton Mifflin Harcourt, 1955).
5. Letter to John F. Kennedy, March 2, 1962, quoted in John Kenneth Galbraith, *Ambassador's Journal* (Boston: Houghton Mifflin, 1969).
6. F.A. Hayek. *Prices and Production* (London: Routledge and Sons, 1931).

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