IRET Congressional Advisory

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ASK NOT WHAT THE FED CAN DO FOR YOU

Several Members of Congress are all a-twitter over recent testimony by Federal Reserve Board Chairman Alan Greenspan and Governor Wayne Angell. Both suggested that the Fed could not offset the anti-growth consequences of the Budget Reconciliation package by easing monetary policy. The Members are acting as if the Fed is breaking some sort of trade agreement: "We'll tighten fiscal policy if you ease money." The Members are "alarmed" (read "scared") that they may be held responsible for the slower economic growth that the tax-and-spend policies will produce, and "concerned" (read "angry") that the Federal Reserve is refusing to bail them out.

> ***...the testimony of the Federal Reserve officials was not that they would not bail out the Congress and the President, but that they could not...The Federal Reserve cannot offset real events, such as a fiscal policy blunder, by printing money.***

The Members are still playing the old game of rearranging the "fiscal-monetary mix", which is akin to rearranging the deck chairs on the Titanic. The Federal Reserve, however, has given up such ineffective pursuits.

Note that the testimony of the Federal Reserve officials was not that they *would* not bail out the Congress and the President, but that they *could* not. The Federal Reserve does not control interest rates as assumed by the fiscal-monetary mix mongers. The mix mongers are mixed up.

Greenspan stated that there is no room for Federal Reserve easing with short term interest rates barely above the rate of inflation (virtually zero in real terms). Short term rates are actually negative after taxes. Others have observed that long term interest rates, after taxes, are not much above the current inflation rate either. These observations are badly phrased. Interest rates can go as low as zero in nominal terms. (But not lower; no one would pay to give money away.) There is no reason, however, why interest rates cannot be negative in real after-tax terms, so long as holding cash is even less attractive after inflation, and the real after-tax-and-regulation returns on additional plant and equipment are next to nothing.

The real reason that the Fed cannot ease further is that faster money growth would raise concern about inflation and raise, not lower interest rates, and raise, not lower, the cost of capital and the cost of production.

The Federal Reserve cannot offset real events, such as a fiscal policy blunder, by printing money. If an act of God cuts output, or a less-than-divinely-inspired tax or regulation raises the real cost of producing real goods or services in the private sector, there is nothing that the Federal Reserve can do about it. Suppose a drought or a flood destroyed half the wheat crop. Could printing more money replace the lost wheat? Suppose the EPA required all cars to be made with $600 catalytic converters, and the higher price reduced car sales. Would printing money cut the cost of other auto parts by an offsetting amount? Suppose a gasoline tax hike raised the cost of gasoline to the consumer. Could cars burn

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additional currency instead? Suppose an income or payroll tax hike tax raises the cost of U.S. labor and reduces employment. Could printing money make U.S. labor cheaper in real terms?

Taxes and regulations raise real costs of production and cut real output. Monetary policy affects the price level, not real variables. Fiscal and monetary policies do not simply pull different strings attached to the same puppet. They control entirely different features of the economy.

Printing money cannot make a business more profitable to offset higher real costs due to taxes and regulation. Printing money may indeed raise the prices that businesses receive for their products, but it also raises nominal wages and the dollar cost of raw materials in proportion. In fact, inflation actually raises the cost of plant and equipment faster than prices because depreciation allowances are not adjusted for inflation. It also raises the real cost of saving because the inflation component of interest rates is taxable.

But what about interest rates? Can't the Fed lower interest rates to offset higher tax and regulatory burdens? No, no, a thousand times no! Please. These are the 1990s. Such psychedelic sophistry was supposed to have succumbed soon after Woodstock. Remember the rising inflation, interest, and tax rates of the late Johnson and early Nixon years? Remember the subsequent 1969-70 recession and the collapse of Bretton Woods? Remember the rising inflation, interest, and tax rates of the Carter years? Remember the new word "stagflation" and the 1980 and 1981-82 recessions?

The Federal Reserve can buy Treasury bonds and pump up bank reserves, which affects the Federal funds rate, the interest rate that banks charge each other on overnight borrowed reserves. Since the Fed action has made reserves more plentiful, and the amount of reserves banks are required to hold is unchanged, the "price" may well fall. However, no one else in the economy has to meet reserve targets, and no one else borrows at that rate. It is an accounting abstraction.

As far as the financial markets are concerned, faster money growth means faster inflation and higher interest rates, especially long rates. There is nothing in faster money growth that would enhance long term real output of the economy, and much that would raise costs and reduce output.

The Members have been captivated by outmoded economic theories. This has led them to recommend outmoded policies. The result would be old fashioned inflation and recession.

President Clinton is right: it is time for a change. So let's see some changed thinking by the Administration and the Congress, and not mix up fiscal and monetary policy.

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Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.