MESSAGE FROM THE PRESIDENT

Jeffrey M. Lacker
President

The past five years have presented the Federal Reserve with a series of difficult challenges. The financial market strains that emerged in the summer of 2007 were at first difficult to diagnose, and even harder to know how to treat as the crisis unfolded.

The recession that began at the end of 2007 required stimulative interest rate cuts, which the Federal Open Market Committee (FOMC) initiated in January 2008, but the subsequent surge in inflation made it difficult to calibrate that stimulus. Beginning in March of that year, distress at a series of financial institutions elicited unanticipated emergency lending, which exacerbated future moral hazard problems. After interest rates were effectively reduced to zero in late 2008, the FOMC provided further monetary stimulus through large expansions of the money supply.

Meanwhile, the federal government's budget outlook has deteriorated markedly over the past five years. The deficit has grown dramatically in the wake of a recession-induced decline in federal revenues and increased expenditures to help combat that downturn. The result has been a significant increase in federal debt. These recent developments have only made more acute what is projected to be a severe long-term problem. The nonpartisan Congressional Budget Office (CBO) issues two long-term federal budget projections. A "baseline" scenario assumes that current laws will remain constant, tax cuts that are set to expire will not be extended, and spending will be held in check as promised. In that scenario, federal debt held by the public would rise slowly over time, increasing from nearly 68 percent as a share of gross domestic product to 84 percent of GDP by 2035 and then remaining relatively constant. That debt level is large, by historical standards, but probably manageable. In the CBO's "alternative" scenario—which it deems more likely to occur—tax revenues relative to GDP would remain close to their historical levels, and spending would increase sharply in both entitlement and discretionary programs. In this scenario, federal debt held by the public would exceed its historical peak of 109 percent of GDP by 2023 and surpass 200 percent of GDP by the late 2030s.

Those projections are alarming, and if they come to pass, they could pose significant challenges for monetary policy, as Renee Haltom and John Weinberg explain in the following essay. If the federal debt were to rise to such levels, it is conceivable that our country could hit what economists call the "fiscal limit," where it would no longer be possible to raise enough money to resolve the fiscal imbalance. The result would be a very unsatisfying choice: federal debt could be reduced through default, or the real level of the debt could be reduced through inflationary actions by the central bank.

Over many years, the Federal Reserve has worked hard to establish and maintain the credibility of our commitment to low and stable inflation. The FOMC recently clarified that commitment by stating that it views an inflation rate of 2 percent as most consistent with price stability over the longer run. Although containing inflation has widespread public support, one must acknowledge that the federal government might be tempted to seek the assistance of the central bank in addressing fiscal problems, especially if those problems become acute. Indeed, there have been calls in some quarters for the Fed to deliberately engineer higher inflation to reduce the real debt burden on private borrowers. It's only a short step from that position to advocating inflation to reduce the real burden of the federal debt or to minimize the interest expense on federal obligations. During World War II, the Fed cooperated with the U.S. Treasury Department to cap interest rates on government debt to limit financing costs, but a massive and intrusive program of federal price controls was required to contain the resulting inflationary pressures. Our country's experience with price controls in the 1970s also was disastrous, so they are not a realistic option.

The current independence that the Federal Reserve enjoys to conduct monetary policy—while remaining accountable to Congress and the public—has helped it stay focused on maintaining price stability. But pressures could emerge that would threaten that independence if the federal government were on the brink of default.

Even more disturbing, inflation still could break loose before the fiscal limit is reached. Research suggests that simply approaching the fiscal limit could be enough to convince markets that the central bank eventually will act to alleviate fiscal pressures. Such expectations could raise inflation without any change in central bank policy.

Apparently, market participants believe that the CBO's "baseline" scenario is, in fact, fairly realistic—that is, the legislative and executive branches will agree on the difficult measures necessary to prevent federal debt from reaching unsustainable levels. After all, the public remains willing to purchase government debt in the form of U.S. Treasury securities at very low interest rates, and inflation expectations remain subdued.

That is a bright sign in what could be a very dreary fiscal picture. But policymakers must not be complacent. Those in charge of fiscal policy must not exploit the public's continued trust to delay difficult compromises. And monetary policymakers must be mindful that a central bank's credibility, once lost, can be recovered only at a steep price.

Jeffrey M. Lacker
President