Preventing the Next Financial Crisis

Don't be fooled by the bond market. Banks are holding prices down because they can buy Treasurys with free money from the Fed.

By ALLAN H. MELTZER

The United States is headed toward a new financial crisis. History gives many examples of countries with high actual and expected money growth, unsustainable budget deficits, and a currency expected to depreciate. Unless these countries made massive policy changes, they ended in crisis. We will escape only if we act forcefully and soon.

As long ago as the 1960s, then French President Charles de Gaulle complained that the U.S. had the “exorbitant privilege” of financing its budget deficit by issuing more dollars. Massive purchases of dollar debt by foreigners can of course delay the crisis, but today most countries have their own deficits to finance. It is unwise to expect them, mainly China, to continue financing up to half of ours for the next 10 or more years. Our current and projected deficits are too large relative to current and prospective world saving to rely on that outcome.

Worse, banks' idle reserves that are available for lending reached $1 trillion last week. Federal Reserve Chairman Ben Bernanke said repeatedly in the past that excess reserves would run down when banks and other financial companies repaid their heavy short-term borrowing to the Fed. The borrowing has been repaid but idle reserves have increased. Once banks begin to expand loans or finance even more of the massive deficits, money growth will rise rapidly and the dollar will sink to new lows. Do we have to wait for a crisis before we replace promises with effective restraint?

Many market participants reassure themselves that inflation won't come by noting the decline in yields on longer-term Treasury bonds and the spread between nominal Treasury yields and index-linked TIPS that protect against inflation. They measure expectations of higher inflation by the difference between these two rates, and imply long-term investors aren't demanding higher interest rates to protect themselves against it. But those traditional inflation-warning indicators are distorted because the Fed lends money at about a zero rate and the banks buy Treasury securities, reducing their yield and thus the size of the inflation premium.

Further, the Fed is buying massive amounts of mortgages to depress and distort the mortgage rate. This way of subsidizing bank profits and increasing their capital bails out these institutions
but avoids going to Congress for more money to do so. It follows the Fed's usual practice of protecting big banks instead of the public.

The administration admits to about $1 trillion budget deficits per year, on average, for the next 10 years. That's clearly an underestimate, because it counts on the projected $200 billion to $300 billion of projected reductions in Medicare spending that will not be realized. And who can believe that the projected increase in state spending for Medicaid can be paid by the states, or that payments to doctors will be reduced by about 25%?

While Chinese government purchases of our debt may delay a dollar and debt crisis, they also delay any effective program to reduce the size of that crisis. It is far better to begin containing the problem before we blow a hole in the dollar and start another downturn.

A weak economy is a poor time to reduce current government spending or raise tax rates, but we don't require draconian immediate changes. We do need a fully specified, multi-year program to restore fiscal probity by reducing spending, and a budget rule that limits the size and frequency of deficits. The plan should be announced in a rousing speech by the president. The emphasis should be on reducing government spending.

The Obama administration chooses to blame outsize deficits on its predecessor. That's a mistake, because it hides a structural flaw: We no longer have any way of imposing fiscal restraint and financial prudence. Federal, state and local governments understate future spending and run budget deficits in good times and bad. Budgets do not report these future obligations.

Except for a few years in the 1990s, both parties have been at fault for decades, and the Obama administration is one of the worst offenders. Its $780 billion stimulus bill, enacted earlier this year, has been wasteful and ineffective. The Council of Economic Advisers was so pressed to justify the spending spree that it shamefully invented a number called "jobs saved" that has never been seen before, has no agreed meaning, and no academic standing.

One reason for the great inflation of the 1970s was that the Federal Reserve gave primacy to reducing unemployment. But attempts to tame inflation later didn't last, and the result was a decade of high and rising unemployment and prices. It did not end until the public accepted temporarily higher unemployment—more than 10.5% in the fall of 1982—to reduce inflation.

Another error of the 1970s was the assumption there was a necessary trade-off along a stable Phillips Curve between unemployment and inflation—in other words, that more inflation was supposed to lower unemployment. Instead, both rose. The Fed under Paul Volcker stopped making those errors, and inflation fell permanently for the first time since the 1950s.

Both errors are back. The Fed and most others do not see inflation in the near term. Neither do I. High inflation is unlikely in 2010. That's why a program beginning now should start to lower excess reserves gradually so that the Fed will not have to make its usual big shift from excessive ease to severe contraction that causes a major downturn in the economy.

A steady, committed policy to reduce future inflation and lower future budget deficits will avoid the crisis that current policies will surely bring. Low inflation and fiscal prudence is the right way to strengthen the dollar and increase economic well being.