ON FISCAL RESPONSIBILITY*

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I gather that the general theme of your proceedings this year is a thing called "fiscal responsibility" and that I'm expected to say something about what constitutes "fiscally responsible" behavior on the part of the Federal Reserve System. This is a subject which I can tackle with some relish, since I have some pretty strong convictions about it.

As a beginner, let me try to pin down a fairly precise definition of the term "fiscal responsibility." This is necessary, I think, because the term tends to be interpreted in different ways by different groups, depending not only on the context but also on the prejudices of the interpreter. As accountants you are concerned chiefly with fiscal responsibility at the individual firm or program level. The term carries an important dollars-and-cents connotation for you and you are, by training, highly sensitive to the unhappy results of lapses from this kind of responsibility. That attitude would serve us well if it could be extended into the public policy area, and sometimes I think it might be a good idea if some training in accounting were required of all office holders in this country.

It's in the area of public policy, unfortunately, that we have different and, too frequently, conflicting notions of what constitutes fiscal responsibility. And these differences are not confined to the politicians. They apply as well to the large group of professional economists who concern themselves with public policy issues. It's clear, I think, that "fiscal responsibility" would mean one thing to Milton Friedman and quite another to John Kenneth Galbraith; one thing to George McGovern and quite another to, say, Strom Thurmond. At one end of some ideological spectrum the term connotes tight government budgets, without deficits, and with a restrictive view of the appropriate functions of government. At the other, it usually reflects a view that fears of high levels of government spending and government deficits should not be allowed to impede government efforts to solve a broad range of social and economic problems so long as the deficits do not exceed a relatively small fraction of GNP. The basic difference here, it should be noted, is one regarding the appropriate role of government and, in effect, pits a dollars-and-cents notion of fiscal responsibility *in* government against some loosely defined notion of social responsibility *of* government that transcends dollars-and-cents considerations.

But these are the extremes and serve mainly to point up my rather strong impression that the term "fiscal responsibility" has tended to become a political buzz word with relatively little substantive meaning. It is tossed around by both so-called conservatives and so-called liberals, both left wing Democrats and right wing Republicans, with all sides using it as a sort of shibboleth to support their respective positions and to cajole their respective constituents. We all like to think we are "fiscally responsible," much as we like to think we are morally upright. And we're all tempted to think that those who disagree with us are "fiscally irresponsible" just as we're tempted to believe that those who don't share our moral values may be of dubious morality.

To avoid difficulties that we get into by using terms so loosely, I'd like to offer you a more specific definition of fiscal responsibility in public policy, one that we can establish a concrete criterion for judging. To do this, it might be useful to make a distinction between government policy at the Federal level and that at the level of state and local government. This distinction is important, I think, not only because Federal policies are more pervasive in their immediate effects but also because Federal policies can have important direct and indirect credit and monetary effects that are not present in state and local government policies.

In any case, let me focus for the moment on policy at the Federal level. Here my criterion for judging the fiscal responsibility or irresponsibility of government policies would be their effects on the value and the integrity of the dollar, in both its domestic and its international uses. Policies that take account of the broad social advantages of maintaining a stable value of our currency are, in my view, fiscally sound. Those that assign little or no value to the stability and integrity of our money I would have to call fiscally irresponsible. What I'm saying here is that policies that promote inflation, or even countenance

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its persistence, are irresponsible in the sense that they are bound to eventuate in hardship for substantial groups in our society or for virtually all groups. At worst they can undermine the bases not only of our economic system but the foundations of our political and social institutions, including our position of political and economic leadership in the free world. But, to emphasize here, the important point is the crucial significance of the value and the integrity of the dollar as the criterion for judging fiscal responsibility.

The remainder of my remarks will be devoted primarily to fiscal responsibility at the level of Federal government policies which, I believe, is the area that you're interested in. In any case, it's only at the Federal level that the Federal Reserve System can play any role in promoting fiscal responsibility. But I don't mean to suggest here that the term "fiscal responsibility or irresponsibility" has no meaning at the state and local government level. State and local governments have been known to persist in policies and fiscal practices that quite justifiably deserve to be characterized as irresponsible. We have a number of contemporaneous cases in point. But the payoff for fiscal irresponsibility at these levels—in economic or political or social terms—is neither as extensive nor as dire as that resulting from fiscal irresponsibility at the Federal level. Also, since irresponsible fiscal behavior at the state and local level has no significance for the stability and integrity of our money, the criterion for specifying it must be different from the specifications at the Federal level. At the state and local level the criterion must be related to the sustainability of the debt encumbrance imposed on taxpayers. Clearly the indebtedness of a state or a locality can assume dimensions that impose undue hardships and perhaps also retard economic development through excessive taxes or through defaults that render capital expansion excessively costly or even impossible.

Budgetary Policy and the Value of Money With these background remarks out of the way, let me return now to the theme of fiscal responsibility in public policies at the Federal level. And at this point I'd like to say a few words about deficits in the Federal budget, which many people seem to equate with fiscal irresponsibility. You will note first that a Federal deficit does not *necessarily* represent fiscal irresponsibility according to my definition of that term. Let me emphasize the word *necessarily*. It is possible for a deficit to be financed in such a way that it does not prejudice the integrity or the stability of the dollar. As a matter of fact, sometimes a deficit may be quite responsible from the public policy standpoint, although my own conviction is that these times are fewer and further between than a good many of my professional acquaintances believe. In any case, it's clear to me that a deficit can be financed without any significant effects on the supply of money or on its value at home or abroad. All that the government has to do is to go out into the market for loan funds and borrow the necessary money, paying the market price, out of the money that's already in existence. It's only when the government undertakes to finance the deficit out of newly created money that the value and the integrity of the dollar is likely to be affected. If the deficits are large and sustained over long periods, the temptation to finance them with newly created money becomes politically irresistible. The reason for this is that the resulting large government demands on our money markets would drive interest rates up to excessive levels and make credit inordinately expensive for private borrowers, both businesses and households, and for state and local governments. To finesse the public hue and cry that would result, the government is highly likely to take what it views as the easy way out and to follow a course that results in the creation of a large amount of new money.

But it usually turns out that this is really not the easy way out. It is only a temporary expedient and, in effect, simply a means of postponing for a time the problem of rising interest rates. As the new money works its way through the economy, prices start rising; that is, inflation sets in. And as inflation gathers steam, two things follow that inevitably push interest rates up. First, higher prices produce an increase in credit demands on the part of businesses, households, and state and local governments. That is easy to see if you consider what happens to the demand for mortgage credit when houses that have been selling for $35,000 go up to say $45,000. The buyer now has to borrow $10,000 more than was necessary before the price increase. This has general application not only to home buyers but also to consumers in general, to businesses, and to governments, all of whom finance a considerable part of their current purchases with borrowed money. The second thing that happens is that suppliers of credit become more reluctant to lend their money at current interest rates. This is because the rising prices mean a steady cheapening of the dollar and lenders know that they will be repaid in dollars that are less valuable in real terms than the dollars they lend. Hence they will demand a premium on their money sufficient to compensate for this cheapening of the dollar.

So with credit demands up and suppliers more reluctant to lend unless they can get a higher return, interest rates quite naturally rise. You can fight this rise for a time by creating more and more new money, but this becomes like the proverbial dog chasing its tail. More analogously, it's like putting yourself on something like "speed" because the more new money you create, the greater the necessity for creating even more.

International Complications Over the past dozen or more years, with the increasing financial integration of the world's major economies, inflation has tended to spawn a new and serious financial complication. The cheapening of the dollar at home has a counterpart in the international exchanges, where the dollar is traded against foreign currencies. We're in a situation now where a cheapening of the dollar at home almost inevitably leads to a cheapening of the dollar abroad. I say "almost" because whether or not the dollar declines in value against other currencies of the world depends on whether inflation over here is proceeding at a pace more rapid than that in other major countries. If all the countries of the world were equally irresponsible fiscally, value relationships among the world's currencies would be unaffected. But if we are more fiscally irresponsible than other countries, then you can expect the value of the dollar in terms of other countries to decline. This is, in fact, what has been happening over the past 18 months, and that should tell us something.

Any sustained decline in the foreign value of the dollar can have serious implications not only for the U. S. economy but also for the economies of the other major countries of the world. Large amounts of dollars are held by foreign monetary authorities as reserves, by central banks and foreign banks, by multinational firms domiciled both here and abroad, and by wealthy individuals. A decline in the value of the dollar means a reduction in the real wealth of these major holders of dollars and this, of course, will have an impact on the economic behavior of these groups. It could, for example, lead to a reduction in their spending, which would mean a corresponding reduction in the level of world trade and investment and hence in economic activity throughout the trading world. Apart from this, any depreciation of the dollar is matched by an increase in the value of other key foreign currencies and this raises the dollar prices of foreign goods. This has important implications both for our economy and foreign economies. Since it raises the prices of our imports it aggravates our own rate of inflation. At the same time it tends to reduce the worldwide demand for the goods of other important countries, like Germany and Japan, and makes problems for them. This kind of situation promotes political attitudes that make for a proliferation of trade barriers among the trading nations of the world and this too tends to reduce the volume of world trade to the detriment of all countries. It is for reasons like this that we cannot reasonably expect to maintain a position of economic and political leadership in the world in the face of a sustained and progressive decline in the value of the dollar.

Role of the Federal Reserve Now I've gotten this far and I've yet to say anything at all about where the Federal Reserve System fits into this picture. The Federal Reserve, you must know, is our central bank. It has the power and the authority to create and destroy money. More correctly, it has the power and authority to vary the rate at which new money is being created at any given time. It should follow from this that if too much new money is being created and inflation is resulting the Federal Reserve is, somehow, to blame—or, at least, that it is implicated in the crime. And, as a matter of fact, there are people, some of them highly respected professional experts, who lay the blame directly at our door.

Now I'm not here to apologize for the Federal Reserve on this particular score. But I think we ought to be careful to give the Fed a fair trial. And to do this it's first necessary to appreciate some unique features of our central banking arrangements. The Federal Reserve differs in some important respects from other central banks that have the power to control money and credit. For the most part, the difference grows out of the greater degree of political democracy that exists in this country compared with the other major countries of the world. This can be seen, I think, when we consider the position of the Federal Reserve in our political system.

The Constitution of the U. S. vests the monetary authority in the Congress of the U. S., i.e., in the elected representatives of the people. Monetary management, of course, is a specialized art that can hardly be carried out by a body of 535 representatives. So, through experience that was sometimes quite painful, Congress early in this century decided to delegate the task of monetary management to a central bank, i.e., to the Federal Reserve. But it has taken pains to insure that the Fed be accountable to Congress and it is clear that our money cannot be managed without regard to the Congressional will.

What I'm saying here, of course, is that despite the talk of an "independent Federal Reserve," the Fed is in fact not independent. Or, if it is independent, it is in a quite unique sense of that term. We are certainly not independent of Congress. If Congress passed a law requiring us to inflate the currency at a 10 percent per year rate, it is difficult to see how we would do otherwise. Also it is not at all clear that we are entirely independent of the executive branch of government, i.e., of the President and the Treasury. The Federal Reserve Act and its many amendments give us some specific duties to perform for the Administration at its command and at its pleasure. So whether we have independent authority to manage money and credit on the basis of our own judgment and in disregard of Congress and the Administration is questionable at best.

Now this brings me to the key question that has to be answered in evaluating the role of the Federal Reserve in this thing that we call "fiscal responsibility" and which I have linked to the necessity of maintaining the stability and the integrity of the dollar. I have noted that large and persistent deficits in the Federal budget, if financed through the creation of new money, must inevitably lead to inflation and to a cheapening of the dollar both at home and abroad. I have also noted that the Federal Reserve, as our central bank, manages the actual operations through which new money is created. Finally, I emphasized that the Fed is accountable to Congress and not altogether independent of the executive. Now the question is this: In the face of large and persistent Federal deficits that exert strong upward pressures on interest rates, how should the Federal Reserve react?

Basically, in such a situation, there are two courses of action open to the Fed, both of which involve risks that could prove serious from the standpoint of the economy's behavior. First, we could ignore the deficits and let the resulting pressures on interest rates show through directly and immediately in our money and credit markets. This would make money and credit significantly more expensive for private borrowers and shift resources directly from the private sector to the public sector. Private businesses would be hurt and the level of activity in the private sector would probably suffer since less capital than otherwise would be available to that sector. To the extent that the private sector makes more efficient use of resources than government does, the overall performance of the economy would suffer. And of course with the rigidities that we have in our economy and in our financial markets, there's always a good chance that a strong upward movement in interest rates could do serious damage to a key sector of the economy, like construction, and through such an effect precipitate a business recession. In any case, this particular course of action would not be accompanied by any significant degree of inflation and may well strengthen rather than prejudice the value of the dollar abroad.

The second course of action would involve resisting the interest rate pressures resulting from the deficits by creating new money. If the deficits were large and we undertook to finance them entirely through the creation of new money, the amount of money in the hands of the spending public would grow at a rapid rate. At some fairly early stage, depending on the rate of resources use at the time the deficits begin, prices would begin to rise. As I noted earlier, this in itself would produce strong upward pressures on interest rates, which would reinforce the pressures generated by continuing deficits. So, in the face of continuing large deficits, efforts to resist rising interest rates through new money creation will succeed only in feeding inflation without moderating upward pressures on interest rates. As a matter of fact interest rates would probably continue to rise as the inflation progressed. And, as I noted, to the extent that our inflation outdistanced that in other countries, our dollar would be cheapened in the foreign exchanges and this too would exacerbate both our inflation and our interest rate problems. So it's clear that any sustained program undertaken to offset the interest rate effects of large, persisting Federal deficits through monetary expansion can lead to no good end. It will inevitably set off a train of economic and financial developments that will lead to some kind of economic impasse, a business slump at best or a major financial crisis at worst.

The moral of the story here is that large, continuing deficits put us on the horns of a painful dilemma. We either have to accept, without resistance, a sharp rise in interest rates that shrinks the private sector and risks a business recession. Or, alternatively, we can launch a program of monetary expansion to resist the interest rate pressures, knowing that, if the deficits continue, the program will not only be futile but will also increase the risks of a serious recession. The fact of the matter is that when large Federal deficits persist over a long period, as they have over the past ten years, the Federal Reserve has no good options.

My own feeling is that the least bad option is to ignore the deficits and let the government, like everyone else, pay the going market price for the funds it needs to borrow. I think we come out much better when we gear monetary growth to the steadily growing money and credit requirements of the private sector, without regard to the borrowing needs of the government except in periods of war or of grave national emergency. But, as either a legal or as a practical matter, it is not clear that we have the authority to follow such a course. The law, as I said earlier, saddles us with some responsibilities to the Treasury in its financing operations. Moreover, Congressmen, sensitive to the complaints of constituents who depend on borrowed money, don't like to see interest rates rise, even when the increases are the inevitable outcome of budgetary and tax legislation that they themselves are responsible for. So in the kind of situation I have been describing all the pressures on us are in the direction of resisting the rate increases through monetary expansion.

These pressures are, of course, of a political nature. And here, I think, it's appropriate to raise the question of whether the Fed should or should not knuckle under to these pressures. It's easy to say that we should not if, in our judgment, knuckling under is not in the public interest; that we should be "courageous." Perhaps we should. But we should keep in mind the point I made about the so-called "independence" of the Fed. We are a creature of, and accountable to, Congress as a Constitutional matter. Can we really afford to substitute our own judgment of the public interest for the Congressional will which, after all, is supposed to be, in our form of democracy, a reflection of the will of the people? Is it appropriate for us to do so? These are the kinds of questions that have to be answered in assessing the Fed's role in promoting fiscal responsibility in our society.