# WHAT SHOULD THE FED DO?

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Two relatively recent developments in the U.S. economy highlight the need for changes in the way the Federal Reserve fulfills its role as guardian of the dollar's value and overseer of U.S. financial markets. To begin with, the almost unprecedented surge in labor productivity fueled by the microchip and the Internet, among other things, demands that the Fed renounce once and for all its ambiguous allegiance to outmoded theories such as NAIRU, output gap, growth speed limits, and such. The past cannot serve as a guide to the future when computers change the way we work at the speed of light. No one, not even the Fed, can know the limits to productivity. Measuring inflation is very difficult these days, given the almost impossible task of calculating the productivity of labor in the service sector. Instead of trying to estimate the economy's supposed growth potential and manage actual growth around it, or trying to target the inflation rate, the Fed should choose an objective target for monetary policy that can be verified and tracked by real-time, market-based indicators of monetary conditions.

Second, today's booming economy has generated an unprecedented flood of tax receipts. As politicians pledge to use the surplus to pay down our multi-trillion dollar national debt, the Federal Reserve should speak out against the conventional wisdom, not support it. The Fed should acknowledge the critical role that Treasuries play in making our financial markets efficient, and their importance in managing the U.S. money supply. Treasury debt is a public good, and we would be ill-served by paying it down to extinction.

Since early 1994, the Federal Reserve has promoted the idea that the road to zero inflation and economic prosperity was best traversed at a stately rather than a hectic pace. Financial markets have been lectured repeatedly on the evils of too-rapid growth, the dangers of tight labor markets, and the illusions of optimistic equity valuations, all ominous conditions that supposedly cannot continue indefinitely without rekindling the fires of inflation and reducing all to naught. This policy approach has not failed to keep inflation under control, but it has exacted an unnecessary cost. When the Fed prescribes higher interest rates for every incremental excess of growth or rise in stock prices, the bond market becomes the whipping-boy of prosperity. In today's booming economy, this results in interest rates that are high relative to historic norms, and more volatile than warranted by underlying inflation fundamentals.

Unfortunately, we now are seeing that the Fed's decision to raise rates in order to slow the pace of economic growth is bearing fruit. Interest-sensitive sectors such as housing and construction have decelerated markedly this year, and consumer demand has also slowed. The growth of private sector payrolls is now at its lowest point in the current business cycle. Tight money has shown up in weak commodity prices, particularly gold, and a very strong dollar, which has risen sharply against most currencies. Oil stands out as the only commodity to enjoy substantial gains against the dollar, but the origins of oil's rise likely have little to do with expansionary monetary policy.

Now that the Fed has apparently achieved its goal of slowing the economy's ascent to higher levels of prosperity would be as good a time as any to change course. We have already heard words to this effect, with one Fed governor after another suggesting that perhaps productivity gains are indeed for real and yes, maybe the economy can after all grow faster than previously thought without spontaneously combusting into higher inflation. Slavish adherents to the Phillips Curve and NAIRU are not far from having to admit that their theories, and not their models' coefficients, are wrong.

It is time for the Fed to pay less attention to such things as the pace of economic growth, the unemployment rate, the condition of the labor markets and the rate of industrial capacity utilization. These indicators are all flawed by measurement errors, time lags, and static assumptions of behavior. Running monetary policy on the basis of traditional indicators of economic activity such as these is no better than driving by looking in the rear-view mirror of a car. The Fed should instead focus on market-based, forward indicators of inflation fundamentals. As our research has shown, and as many of the participants in today's conference have argued for years, there are only a handful of financial market tea leaves which a central bank need consult for guidance.

First and foremost is the value of the dollar. Inflation is fundamentally a monetary phenomenon, as Milton Friedman has so often reminded us. Inflation happens when the supply of money exceeds the demand for money. The fundamental logic of supply and demand tells us that if the quantity of money exceeds the demand for it, the value of money will decline and we will experience inflation. Since inflation is characterized by the loss of purchasing power of the unit of account, the impressive increase in the dollar's purchasing power over the past four years is a sign that we actually should worry more about deflation than about inflation.

Another important indicator of inflation is the level of real interest rates. Thanks to the foresight of former Treasury Secretary Rubin, today we have TIPS to tell us where real interest rates are. We no longer have to rely on historical and potentially flawed measures of inflation to deflate nominal interest rates. We simply check the level of real rates on 5, 10, and 30-year TIPS. When real rates are high, like now, we know that inflation risk is low, because demand for TIPS is low. Low real rates would tell us, as they did in the 1970s, that Fed policy was falling behind the inflation curve, and that tighter policy was called for; in an inflationary environment demand for TIPS would rise and their real yields would fall.

The third leading indicator of inflation is the price of gold. Jude Wanniski has aptly termed gold the North Star by which central bankers can steer a course to monetary stability.

Today's weak gold price is telling the Fed to relax. Investors are not interested in gold because money is not in excess supply, and better returns can be had in stocks and bonds than in gold, the proxy for all things that are not financial assets.

The fourth indicator of inflation fundamentals is the shape of the yield curve. A steep curve tells us that investors demand higher interest rates in exchange for locking up their money for longer maturities and risking the loss of their purchasing power. In other words, a steep yield curve signals a high probability that monetary policy has an inflation bias. A flat or negatively-sloped yield curve has almost always been a sign of very tight monetary policy. If investors are willing to extend maturities for a slight or even negative incremental gain in yield, they must have high confidence in the anti-inflation stance of monetary policy.

The first three of these indicators have been telling us for quite some time that monetary policy is tight and inflation risks are low. If the Fed had been paying attention to these indicators, instead of indicators of the economy's growth rate, they would not have tightened policy as much, and the economy might be even stronger than it is today. And the bond market would have been much less turbulent.

But it is the interaction of the fourth indicator—the shape of the yield curve—with the burgeoning federal surplus that highlights the reason for my second recommendation for how the Fed should change its ways. A continuation of current economic growth and budget trends could mean that the marketable supply of Treasuries might be extinguished in as few as seven years. What price would the Treasury have to pay to buy back the last long bond? How much of the current inversion of the yield curve is due to tight money, and how much is due to speculation over the potential scarcity value of Treasuries? We can guess that the potential scarcity value of Treasury bonds is 20 to 50 basis points or more, but that number, whatever it is, fluctuates with every bump in the economy and every pronouncement of politicians seeking to influence the future course of fiscal policy.  As long as fiscal policy remains focused on repaying the national debt, the shape of the Treasury curve will be an ambiguous indicator of the effective stance of monetary policy because medium- and long-term Treasuries will carry a positive, variable and unknown premium.  Thus the information content of the slope of the yield curve as an indication of monetary policy will be seriously compromised as long as we pursue policies aimed at paying down the national debt.  It is not in our interest to lose such a valuable indicator of inflation fundamentals.

The Fed should speak out against paying down the national debt for two other very important reasons.  First, Treasuries have become an indispensable and valuable part of the global financial markets. It is not difficult to show that paying down the national debt could cost our economy a significant fraction of the cost of servicing that debt.  Second, Treasuries are the reserve asset backing up not only the dollar but most other national currencies.  Eliminating Treasuries could have disturbing consequences for the conduct of monetary policy worldwide.

What would the world do without the risk-free asset we all know and love called Treasury securities?  That is equivalent to asking how the world would function without an agreed-upon standard for the weight of a kilo or the length of an inch.  Risk-free Treasuries are to global financial markets what Greenwich Mean Time is to global time keeping.  We could live without them, but not quite as well.  In order for financial markets to be efficient, they must have a risk-free standard against which to measure everything that is risky.  Imagine what would happen if the world had several different standards for the correct time, the length of a meter, or the weight of a ounce.  Global commerce could still function, but much less efficiently.  If the zero meridian were an unknown or fluctuating location, we could establish time locally by referencing the position of the sun, but think how difficult it would be to schedule a conference call between globally-based participants for noon, local time in Pasadena. An uncertainty and inefficiency premium would have to be built into every aspect of our lives.

Treasuries form the backbone of all fixed income markets, because they define the risk-free rate for maturities ranging from 1 day to 30 years. All other debt is measured against Treasuries in terms of a spread. Money managers like us sell one billion dollars of mortgages for a duration-equivalent amount of Treasuries at an agreed-upon spread in the blink of an eye, without increasing our market exposure. Without Treasuries, transactions of this sort would become more risky and therefore more costly.

Not only would all fixed-income transactions, which sum to almost $500 billion per day, carry an additional uncertainty premium, all new issuance of fixed-income securities would cost the issuer more because yields would be higher than otherwise. Each basis point of yield uncertainty would cost us over $6 billion per year. With typical bid/ask spreads for fixed-income transactions of 3 basis points and more, ratcheting up all transaction costs by one increment would cost us about $40 billion per year. Corporations issue hundreds of billions of new debt every year, and homeowners take out even more hundreds of billions in mortgages every year. If they had to pay an incremental yield of just 0.25 percent, the extra cost could be $6 billion per year. Using these very conservative and limited assumptions we are already looking at a cost of about $50 billion per year to do away with Treasuries, just less than half the cost of servicing a $2 trillion debt at current yields of 6 percent. And this could be only the tip of the iceberg: what about the impact of no Treasuries on the equity market, or on the many hundreds of billion dollars transacted every day on the foreign exchange, derivative, and swap markets? It is not unreasonable, I think, to say that the cost of eliminating our national debt is on the same order of magnitude as the cost of servicing it.

I would like to suggest that the Fed propose an easy and appealing alternative to paying down the debt. Policymakers could set an objective of maintaining a prudent level of marketable debt—say, 20 percent of GDP—in order to keep financial markets efficient. That's a little less than current levels of 25 percent of GDP, and historically, that is a very small number but still adequate to qualify as a large and liquid market. Once the debt reaches this level, the government could simply refund taxpayers their pro-rata share of any surplus. This would obviate the difficult debate over whose taxes to cut and by how much. It would also give everyone an incentive to pursue growth-maximizing policies, since more-rapid growth would automatically generate the tax cuts necessary to keep the stock of debt growing at the same pace as the economy. A liquid, permanent Treasury market would give markets a stable, risk-free benchmark, ensuring maximum efficiency, minimum transaction costs, and the lowest possible interest rates. Altogether, such a policy would solidify the U.S. economy and the dollar as the world's financial superpower.

But let's not forget the other reasons for not paying off our national debt. Paying off the national debt would be important if our debt were large, but it is not. Today it represents only one-third of our GDP, and it is declining rapidly relative to our growing economy. There is no evidence to suggest that this level of debt has any adverse impact on our interest rates or on our economy. Indeed, our debt burden is one of the lowest of any of the developed economies.

From a financial perspective, paying off the federal debt is a lousy investment. Buying back Treasury bonds would produce a return on investment for taxpayers of only 6 percent a year, since that is the average cost of servicing our debt. If we returned the surplus to taxpayers by cutting taxes, I am confident that most Americans could find a way to invest that money—either by paying down credit card debt carrying double-digit interest rates, or by investing in the stock market—that would ultimately produce returns significantly greater than 6 percent a year.

Finally, we must remember that the Federal Reserve uses risk-free Treasuries—the best and most popular reserve asset in the world—to manage our money supply. Would we want the Fed to buy risky assets to back the dollar? Treasuries are also the risk-free asset of choice of most of the world's central banks.

The world needs Treasuries, and would be worse off without them. They are a public good just like our justice system, our national defense, and our network of interstate highways. We are lucky to be the biggest and most powerful economy in the world, because that allows us to turn a prudent amount of our debt into an asset, not a liability. We would be foolish to pay down the national debt.

The Federal Reserve should recognize the new dynamics of the world economy and choose an objective target to manage monetary policy. It should bury the Phillips Curve and stop fighting prosperity. And it should become an advocate for retaining a prudent amount of Treasury debt in circulation, since this would be to everyone's benefit.