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On Federal Deficits and Debt, Monetary and Fiscal Policy

By

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ABSTRACT

President Biden signed a $1.9 trillion COVID relief package (the "American Rescue Plan") on March 11, 2021[1]. Without a corresponding increase in taxes, this plan has set off alarm bells for those concerned about the expansion of government deficits and debt. Mainstream economists have raised issues of excessive inflation, "crowding out" of private sector investment, and an unacceptable repayment burden on the young and future generations.

The purpose of this paper is to demonstrate that these concerns are based on a misunderstanding of the role played by the deficit, debt, and taxes in the U.S. economy, even a misunderstanding of how certain parts of the U.S. financial system actually work.

The paper explores the beginnings of paper (fiat) currency and government bonds[2] in the U.S. and demonstrates that without federal deficit spending, the private sector would lose steam and face a recession. Without federal bonds, the government would lose a lever to control interest rates and inflation, not to mention the private sector's loss of a risk-free, interest bearing alternative to cash.

This is not to say all deficits (or all government expenditures, for that matter) are good. Some actually do cause excessive inflation, exacerbate

[1] The President has also proposed infrastructure spending plans expected to cost over $3 trillion. They are not addressed by this paper as details are still being negotiated.
[2] The terms "government bonds" and Government debt" will be used interchangeably.

wealth disparity or have other harmful effects. These are serious problems and they need to be addressed effectively. Simply raising taxes in an amount to match the spending is an example of an approach with limited effectiveness.

The ideal is for large spending programs to be designed to be "inflation neutral," that is, to include federal revenues (taxes) that are specifically designed to mitigate the inflationary impact of spending, to the extent and place it is expected to emerge. If that is not possible, then increased taxes, while possibly serving political, social, or other purposes, are not the solution to address excessive spending-induced inflation.

The problem is, when excessive inflation emerges, the most frequently used tool for addressing it, monetary policy, has the pernicious effect of exacerbating the hurt on the most vulnerable citizens, lower paid workers and, especially, people of color.

This paper will also address deficiencies in fiscal and monetary policies, ideally before they actually become serious.

In his press conference on March 25, 2021, President Biden identified the "battle between the utility of democracies in the 21st century and autocracies" as the real threat to the United States, noting that "We've got to prove democracy works."[3] The point of this paper is that only with a proper understanding of how our financial system actually works can our leaders make the best decisions impacting our nation for decades to come.

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Introduction

From a very young age, we were taught that things borrowed needed to be returned, especially if it was money. We were also taught that we couldn't spend money we didn't have or had to borrow it first from

[3] "Biden Defines His Underlying Challenge With China: 'Prove Democracy Works,'" *The New York Times*, March 26, 2021, https://www.nytimes.com/2021/03/26/us/politics/biden-china-democracy.html.

someone else, like a bank. Eventually, what was borrowed needed to be repaid.

Both of these lessons – the need to borrow before spending money we didn't have and the need to repay debt – have become part of our national psyche. We have become wired to think this way in our everyday lives. It seems common sense that these truths would also apply to the federal government[4].

But here's the point: for a sovereign country such as the United States with its own fiat currency that is not pegged to a commodity like gold or to another country's currency, the truth is just the opposite from what we've learned:

- The federal government does not need to collect taxes before it spends and, in fact, it never has;
- Nor does the government need to borrow before it spends and, in fact, it never has[5];
- When the federal government spends more than it takes in in taxes (a "fiscal deficit"), the economy expands and the nation becomes wealthier, not poorer; and
- When the government borrows (sells Treasury securities), it need never be paid back[6]. In fact, paying it back can lead to harmful effects on the economy.

In order to understand why federal deficits and debt do not have the same meaning as personal, business, or municipal deficits and debt, it is necessary to take a step back and understand where state money came from in the first place.

[4] In reality, many debts go unpaid as businesses and even individuals roll over their debts to new ones. Despite that, the view that federal debts need to be eventually repaid is dominant.

[5] While it is a political choice to do so, it is not required in a nation such as the United States. See: http://www.levyinstitute.org/pubs/wp244.pdf and http://home.hiwaay.net/~becraft/BeardsleyRuml.pdf and http://www.levyinstitute.org/pubs/wp_792.pdf

[6] Though it may be useful to reduce the debt at times to manage inflation and interest rates. See: https://www.youtube.com/watch?v=WS9nP-BKa3M and https://www.dissentmagazine.org/online_articles/monetary-mythbusting-an-interview-with-stephanie-kelton

Where Does Money Come From?

In Colonial times, prior to the first paper money being issued, British, German and Spanish coins, in addition to coins produced by some of the colonies, were used as currency.[7] In 1690, the Massachusetts Bay Colony was the first to issue paper money by any government in the Western world[8] to pay for military action during King William's War in French Quebec.[9] This money was called a bill of credit and carried with it a promise to be acceptable in payment of taxes.[10]

Thus, from the very earliest days, paper money was issued to buy goods and services and was made valuable by being made acceptable for payment of taxes. Subsequent versions of paper money were developed, all of which had these same basic characteristics of being first spent by the government and given value as a means to pay taxes.

However, there were periods when so much paper currency was issued (and counterfeited) that it lost much of its value[11]. This was an important lesson that eventually led to establishment of national bond issuance as will be discussed below.

To standardize transactions within and among countries, paper currency in different countries began to be tied to gold as world trade expanded in the mid-1800's. The U.S. adopted the gold standard in the early 1870's (the U.S. had been on a silver standard since 1785). The country went off the gold standard in 1933 and completed the process by stopping the

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[7] The United States Mint, https://www.usmint.gov/learn/history/us-circulating-coins#:~:text=Coinage%20Act%20of%201792&text=The%20Mint%20delivered%20the%20nation's,bulky%20size%20for%20small%20change..

[8] "A History of American Currency," http://numismatics.org/a-history-of-american-currency/#:~:text=When%20paper%20money%20was%20issued,funded%20in%20a%20similar%20way.

[9] https://www.uscurrency.gov/history and https://www.newenglandhistoricalsociety.com/massachusetts-issues-first-paper-money-western-world-pay-king-williams-war/#:~:text=Late%20in%20the%2017th,coins%20then%20in%20use.

[10] While personal income taxes were not levied until 1861 to help pay for the Civil War, taxes were levied in Colonial times based a variety of things including property and excise taxes; TheBalance.com., https://www.thebalance.com/us-federal-tax-history-4145479. These taxes were repealed 10 years later. Personal income taxes did not get ratified until 1913 with the 16th Amendment to the Constitution.

[11] https://www.uscurrency.gov/history; The first national paper currency, called "Continentals," was issued by the Continental Congress in 1775 to purchase goods and services for the American Revolution.

conversion of dollars to gold (the "dollar peg") in 1971. Thus, the dollar became "fiat" currency (not backed by a commodity) at that time.[12]

Over time, it was learned that if too much currency was required to pay taxes, it led to too much currency being taken out of circulation. It was also learned that it was unnecessary and counterproductive to tax back most of the currency issued in order for it to retain its value and be used for commerce generally[13]. With a growing population, it became necessary to provide ever more dollars to the private sector lest scarcity would result and the dollar's usefulness in commerce would be impaired.

In summary, the source of money as we know it is and always has been government spending, and the net increase in the money supply is and always has been derived from government spending in excess of tax collections.

Today, the process of federal government spending is conceptually unchanged from the time when paper currency was first introduced. When the federal government spends, the bank accounts (deposits) of suppliers are increased by the Federal Reserve[14] acting as the paying agent for the Treasury, increasing the money supply. At the same time, to keep the bank's balance sheet balanced, the Fed credits the bank with reserves[15].

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[12] The Balance, https://www.thebalance.com/what-is-the-history-of-the-gold-standard-3306136#:~:text=European%20countries%20wanted%20to%20standardize,gold%20standard%20by%20the%201870s.&text=When%20World%20War%20I%20broke,pay%20for%20their%20military%20involvement.

[13] "Modern Money Theory and Interrelations between the Treasury and the Central Bank: The Case of the United States," Eric Tymoigne, Levy Economics Institute of Bard College, March 2014. The characteristic of being acceptable for paying taxes gave the currency value.

[14] This is an electronic transaction. At this point, no new currency is created. That occurs when the Federal Reserve orders new currency from the Bureau of Engraving and Printing which is then sent to member Reserve Banks which are required to pledge collateral (usually in the form of U.S. Government securities) against the currency. https://www.newyorkfed.org/aboutthefed/fedpoint/fed01.html#:~:text=The%20Federal%20Reserve%20orders%20new,cost%20varies%20slightly%20by%20denomination.

[15] Bank reserves are a unique form of currency that are used by commercial banks to support interbank transfers among depositors. They are created and destroyed by the Federal Reserve in the process of conducting monetary and fiscal policy. Bank reserves are not considered part of the money supply nor are they the basis for commercial bank loans. See: https://www.federalreserve.gov/aboutthefed/section19.htm

When taxes are levied, bank accounts are debited and the money supply contracts along with a reduction in the bank's reserves. The difference is an increase (or decrease) in net financial wealth for the nation, the only source of change in net financial wealth.[16] Except for requirements relating to appropriations bills discussed below and observance of potential inflationary impact, from a technical perspective, there is no impediment for the government to spend before taxes are levied or bonds are issued.[17]

There is a popular misconception about a source of money that needs to be clarified, namely, that the Federal Reserve "prints money" that is added to the nation's money supply. This is not true.

What is true is that the Fed creates and destroys reserves[18] in support of fiscal policy (spending and taxing by Congress) and monetary policy (through open market operations). Reserves are not included in the definition of the money supply.

So, why do we have taxes?

If taxes are not required for federal government spending[19], why do we have them. First and foremost, as suggested above when describing the first paper currency in the U.S., taxes give currency worth. Today, it is

[16] In addition to government spending, there are two other periodic incremental sources of money supply to be recognized. When banks lend, they create demand deposits ex nihilo which are offset on the bank's and borrower's balance sheets by the promissory note. This is money that did not exist previously and adds to the nation's money supply but does not add to net financial wealth since it is offset by the borrower's obligation to repay. The second source of change to the money supply during a period is the change in foreign held dollars occurring as a result of trade and financial flows with other countries.

[17] Overdrafts on the Treasury's account can and do occur. While legislative requirements lead to restoration of the Treasury's account, this is not technically required to support spending and no harm is done.

[18] Banks are required by the Federal Reserve to maintain a level of reserves (balance sheet assets) against their "transaction accounts" (balance sheet liabilities, basically, an account subject to withdrawals by the account holder). The Fed controls the amount of reserves in the banking system in order to manage interest rates and the smooth functioning of the financial system. Reserves may only be used for interbank transfers, interbank loans, in exchange for securities as part of the Federal Reserve's open market operations and as part of fiscal activities (spending and taxing). Reserves are considered part of the "monetary base," but are not counted as part of the money supply (M1, M2, etc.) and are not used to purchase goods and services.

[19] Unfortunately, the view that taxes ARE required to support government spending is spread by some of the most notable economists in the country, including Nobel Laureate Joseph Stiglitz in his article "The Starving State; Why Capitalism's Salvation Depends on Taxation" in the January/February issue of *Foreign Affairs*, in which he says "The state requires something simple to perform its multiple roles: revenue." It's just not true.

mostly bank deposits that have worth as they are the primary means of paying federal taxes (making payments with cash is also allowed).

But taxes have other purposes, as well. In 1946, Beardsley Ruml, then Chairman of the Federal Reserve Bank of New York, wrote "Taxes for Revenue are Obsolete," in which he summarized the purposes of taxes quite well:

What Taxes Are Really For

Federal taxes can be made to serve four principal purposes of a social and economic character. These purposes are:

1. As an instrument of fiscal policy to help stabilize the purchasing power of the dollar;
2. To express public policy in the distribution of wealth and of income, as in the case of the progressive income and estate taxes;
3. To express public policy in subsidizing or in penalizing various industries and economic groups;
4. To isolate and assess directly the costs of certain national benefits, such as highways and social security. [20]

The first purpose listed, "to help stabilize the purchasing power of the dollar," is more complicated than it might seem. For example, simply having tax offsets in spending bills does not necessarily result in controlling inflation.[21] Accordingly, Congressional Budget Office analysis of the budgetary impact of spending bills is not a useful guide to their inflationary impact.

Federal Deficits Increase National Wealth

The above analysis describes where money comes from and how federal government deficits add to the nation's money supply and wealth. But

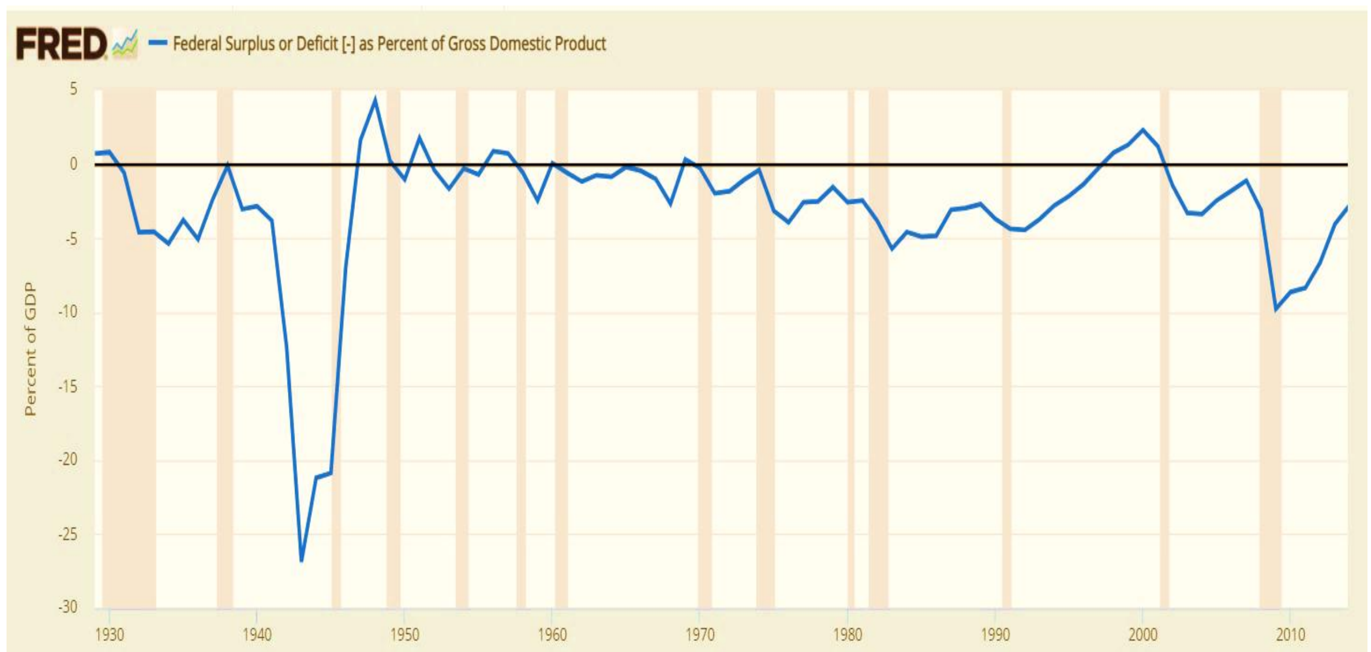
[20] Ruml, B. 1946. "Taxes for Revenue are Obsolete." *American Affairs*, January.
[21] Stephanie Kelton, "Biden Can Go Bigger and Not 'Pay for It' the Old Way," *The New York Times,* April 7, 2021

what actually happened when the government ran a surplus, that is, collected more in taxes than it spent in a given period?

There have been seven times in U.S. history when the government ran surpluses and commenced paying down the debt, each of which was followed by, and implicitly caused, a severe recession or depression.[22]

The chart below shows the annual federal surplus or deficit as a percentage of GDP with the vertical bars indicating periods of recession. Here we see a strong relationship between times when the deficit as a percentage of GDP approached zero and subsequent recessions.

It is logical that federal surpluses lead to recessions. A federal surplus withdraws financial resources from the private sector which in turn leads to a contraction of business activity, rising unemployment and, eventually, recession.

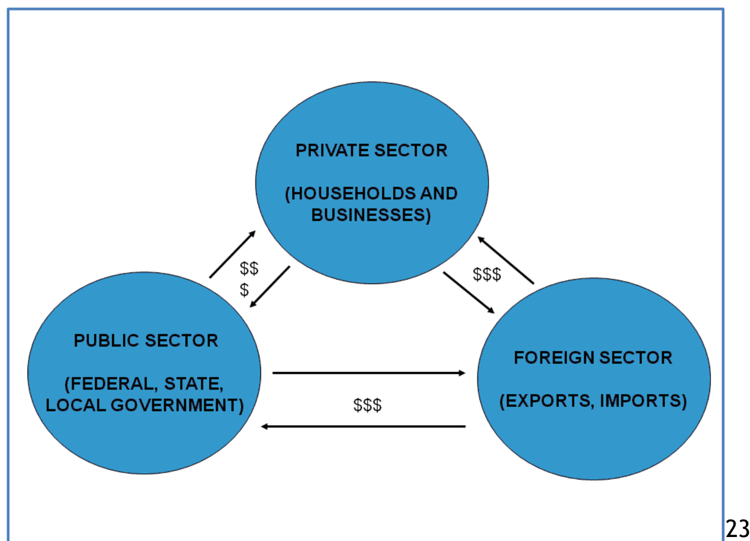


Source: Economic Research, Federal Reserve Bank of St. Louis

[22] While every government surplus was followed by a recession, not every recession was preceded by a federal surplus. https://www.cfo.com/the-economy/2018/11/the-federal-government-does-not-need-revenue/ and https://mythfighter.com/2009/09/07/introduction/.

The Sectoral Balance

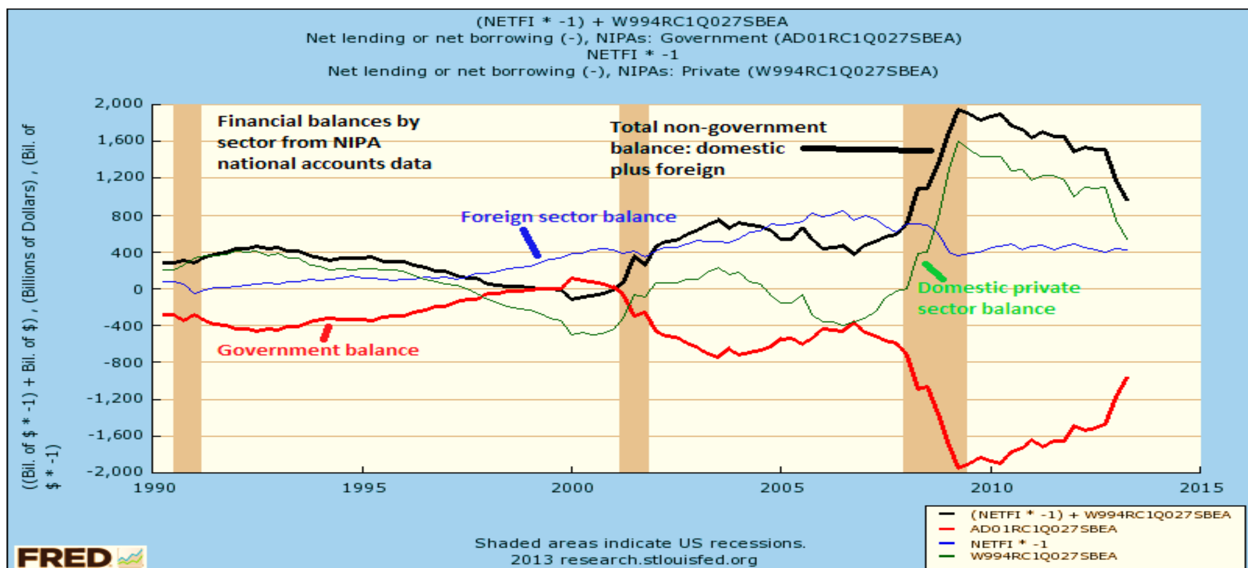
While the above analysis describes how deficits add to the nation's money supply, it can also be shown with something called the "sectoral balance," an accounting identity that equates financial flows between the non-government (private) sector with the sum of the government (public) and the foreign sectors developed by British economist Wynne Godley.

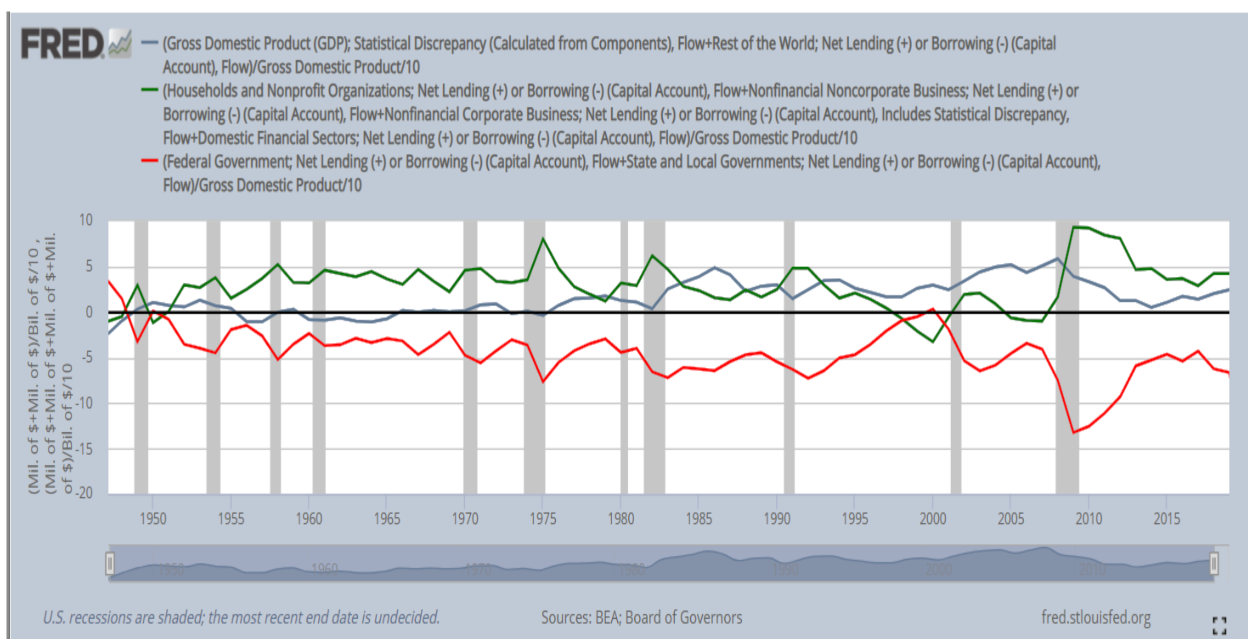


[23]

These next two charts illustrate the sectoral balance – how government deficits result in private sector surpluses.

[23] http://neweconomicperspectives.org/2009/07/sector-financial-balances-model-of_26.html





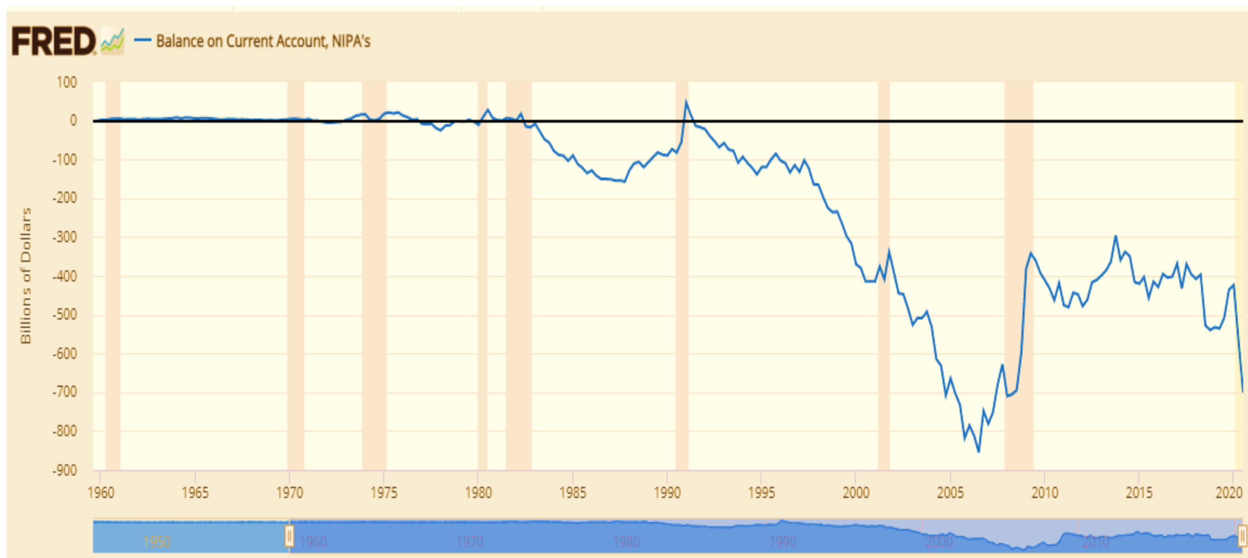
Source: Economic Research, Federal Reserve Bank of St. Louis

A private sector surplus (savings in excess of investment expenditures) must, by definition, equal the sum of the fiscal deficit plus the current account balance (basically, the trade balance).

This analysis has significant implications for U.S. industrial policy (and President Biden's current proposals for infrastructure expenditures) in

that as long as the current account balance is negative[24] (generally, imports exceeding exports), the federal deficit must be greater than it otherwise would be in order for the private sector financial balance to grow. This increase in the federal deficit creates political pressure to spend less or tax more, both of which are met by fierce objections in Congress.

Federal deficits lead to popular distaste despite their accretive value to the private sector's net financial wealth. In response, a robust national industrial policy that had the result of reducing the need for high value and critical product imports would result in a reduced need for fiscal deficits or tax increases while, at the same time, boosting domestic employment.



Source: Economic Research, Federal Reserve Bank of St. Louis

This is not to say that imports don't have value as they provide a means of helping to control inflation by allowing consumers to buy lower priced goods, an especially useful geopolitical exercise depending on the trading partners.

[24] The last time the CAB was positive was in 1991 and has been substantially negative ever. For the three fiscal years ending June 30, 2020, the current account balance has averaged negative $471 billion according to the Federal Reserve Bank of St. Louis, FRED Economic Data.

Having shown how federal deficits increase the nation's net financial wealth (other things being equal), we'll now turn to an analysis of the federal debt.

Why Do We Have Government Bonds?

Now that we have learned that the government spending precedes taxes and is not limited by them, why did we really need government bonds?

There is considerable misunderstanding about the national debt as most observers – and many economists – consider it like a personal or business loan, that is, that it is necessary to support federal government spending and needs to be repaid. Neither of these views are true.

First, it needs to be understood that government debt was not the same as government issued bonds in the early years of the country. In fact, the country was in debt almost from its inception with the earliest recorded analysis of debt in 1790 by Alexander Hamilton in a report to Congress[25].

Hamilton was keen to demonstrate to creditors that the country could pay its debts and first turned to tariffs and other forms of taxation. Given the experience of the Revolutionary War, increased taxes at that time were not met with enthusiasm, to say the least.

Accumulated debt in Hamilton's time was largely a result of financing wars, especially the Revolutionary War, but the debt actually began 100 years earlier with the Massachusetts Bay Colony issuing "bills of credit," or IOUs, as described above. Subsequent debts mounted with the War of 1812, the Civil War, and wars the followed.[26]

While recorded government deficits go back to at least 1901[27] and much further back based on the experience of the Massachusetts Bay Colony in 1690, it was the experience of producing too much currency (too many

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[25] The Smithsonian Magazine, https://www.smithsonianmag.com/sponsored/alexander-hamilton-debt-national-bank-two-parties-1789-american-history-great-courses-plus-180962954/

[26] *The Atlantic*, https://www.theatlantic.com/business/archive/2012/11/the-long-story-of-us-debt-from-1790-to-2011-in-1-little-chart/265185/

[27] According to the Federal Reserve of St. Louis FRED database, https://fred.stlouisfed.org/series/FYFSD.

Continentals) and its subsequent devaluation that led the U.S. government to issue its first bond, called loan or debt certificates, to help finance the Revolutionary War.

It wasn't until 1917 that the first U.S. Treasury bonds, called Liberty Bonds, were issued, with a stated purpose to fund World War I[28]. In fact, what Liberty Bonds did, as did Series E war bonds for World War II, was to remove consumer demand for goods and services to offset the demand from the government for war goods and, in this way, controlled inflation.

Source: *The Atlantic*, https://www.theatlantic.com/business/archive/2012/11/the-long-story-of-us-debt-from-1790-to-2011-in-1-little-chart/265185/.

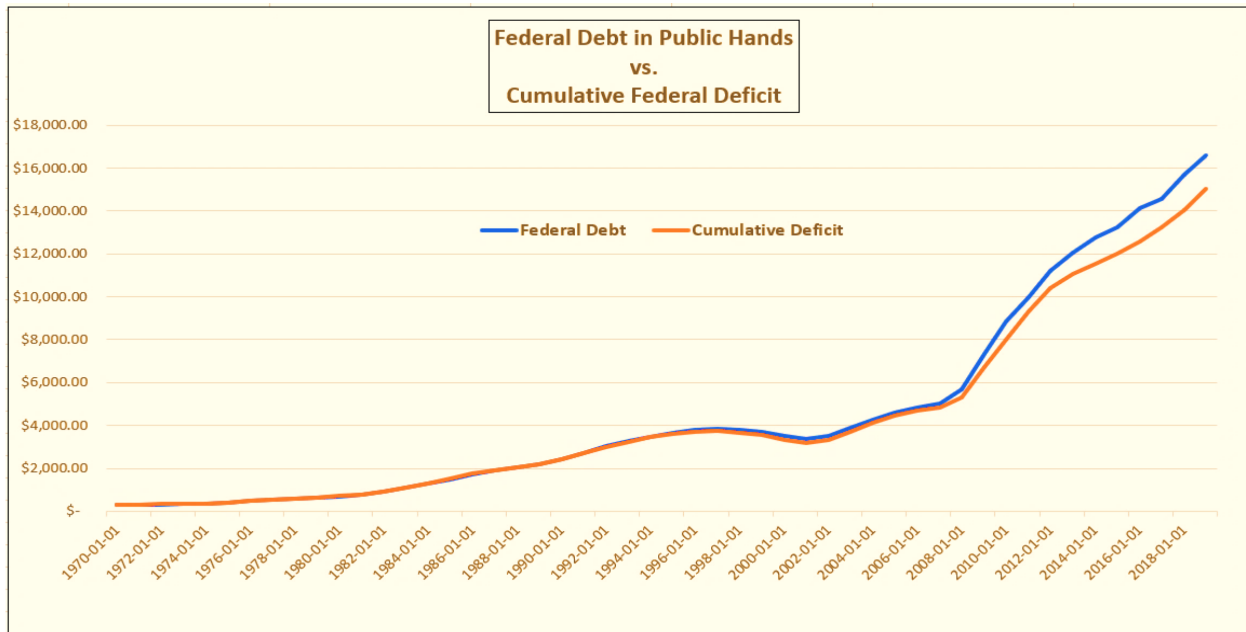
Recalling that spending precedes taxes, the federal government has always had the ability to create money out of thin air.[29] Therefore, the

[28] http://bondfunds.com/education/a-brief-history-of-bond-investing/#:~:text=The%20First%20U.S.%20Treasury%20Bond&text=In%201917%2C%20the%20First%20Liberty,States%20declared%20war%20on%20Germany.

[29] Alan Greenspan, former Chairman of the Federal Reserve once remarked: "…, the United States can pay any debt it has because **we can always print money to do that.** So, there is zero probability of default." Ben Bernanke, Greenspan's successor later said: "But **the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes** at essentially no cost." Note that money is not actually printed but electronically credited to the seller's bank account. (Emphasis added.)

real motivation for issuing bonds was not to finance a war but to avoid the inflationary impact of resource constraints (too much money chasing a limited supply of goods).

While it is true that the federal debt in public hands[30] has tracked closely with the deficit as shown in the chart[31] below, there are two primary reasons why this is so in today's world:



Source: Economic Research, Federal Reserve Bank of St. Louis

- First, when a spending bill is passed by Congress, it is funded by means of a separate appropriations bill. In today's legislative environment, consistent with the common (but inaccurate view) that funds must be present before they are spent, the following language is added to every appropriations bill:

  "Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the following

[30] The total federal debt includes about $6 trillion of non-tradable which is not included int the federal debt in public hands. The non-tradable debt is held in the Social Security trust fund and certain government retirement programs.
[31] This is the latest annual information available from the FRED website. The total federal debt in public hands was over $21 trillion at the end of the third quarter of 2020, including about $7.5 trillion held by the Federal Reserve. Another $7 trillion is held in intergovernmental accounts, like Social Security.

*sums are appropriated, **out of any money in the*** **Treasury not otherwise appropriated**, for…"

For further proof that the government does not need to tax before it spends, consider where the money comes from in the first place. As discussed above, had it not been for government spending, the money to satisfy tax liabilities and "support" spending would not be there. Therefore, it is technically unnecessary for the government to borrow in order to spend.

- Second, one needs to know how and why the Treasury issues (sells) debt other than to accommodate appropriations bills. The Office of Debt Management (ODM) within the Treasury Department is responsible for providing advice and analysis on matters related to the Treasury's debt management policy, the issuance of Treasury and federally-related securities, and financial markets.[32] The Office works closely with the Treasury Borrowing Advisory Committee and market participants to manage Treasury borrowing needs. ODM expresses its objectives as follows:

- Our Debt Management Objectives
  - **Regular and predictable**
  - **Least expected cost over time**
  - Managing interest rate risk
  - Supporting market functioning and liquidity
  - Maintaining a broad investor base
- Constraints
  - Uncertainty – (Sources: legislative commitments, macro-economic forecast errors, technical modeling factors all create uncertainty in deficit forecasts)

[32] https://home.treasury.gov/about/offices/domestic-finance/financial-markets

Other than to accommodate appropriation bills, the Treasury issues debt principally to manage interest rates and inflation, not to prefund government spending[33].

Is government debt (Treasury bonds) a bad thing, something to reduce or eliminate like household debt? The answer is no. It is one of the tools of the federal government to manage interest rates. But that's not all.

While some may wish to eliminate government debt, to do so would cause havoc in the domestic and global financial system[34]. Think of debt this way: as a riskless financial instrument, it becomes an interest-bearing form of dollars. As such, it provides an essential role in the economy by providing a safe haven investment for domestic and foreign investors.

Does government debt "crowd out" private sector investment?

It is sometimes argued that federal debt "crowds out" private sector investment[35]. The premise is that government debt absorbs investment funds that would otherwise be used to support growth in the economy. That argument doesn't hold for at least these reasons:

- Federal debt issued as a consequence of a federal deficit is matched by an increase in the money supply as a result of the government spending, increasing funds for private investment, not decreasing them;

- Federal debt is sold mostly to primary dealers (designated banks and financial institutions) in exchange for reserves and, as noted previously, reserves are not part of the money supply and not the basis of commercial bank lending;

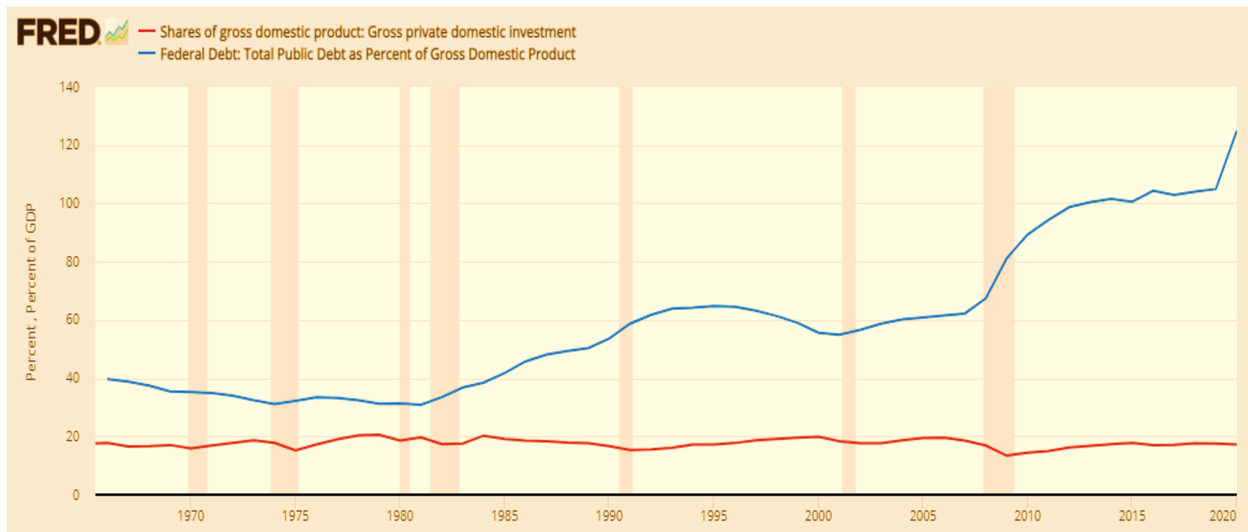
[33] This may be the reason why government debt has grown faster than the deficit since 2008.
[34] Actually, federal debt owned by the Federal Reserve, currently about $7.5 trillion, could be interpreted as no debt at all since proceeds at maturity, if held that long, are returned to the Treasury.
[35] The crowding out theory is frequently – and erroneously – presented in economics textbooks.

- When primary dealers sell their bonds to investors, it is the investors choice to hold federal debt rather than an alternative of comparable risk. Risk-taking private investors are in no way hampered or constrained to make investments on account of Treasury bond issuance;

- Higher interest rates, should they occur, would induce foreign investors to purchase U.S. government bonds, thereby moderating domestic interest rates[36]; and

- Crowding out assumes a fixed money supply which, in the case of federal deficit spending, is patently not the case as discussed above.

This chart shows that as the federal debt has grown as a percent of GDP, gross private domestic investment has been unaffected, remaining largely steady at 18-20% of GDP, dipping, as expected, during recessions.



Source: Economic Research, Federal Reserve Bank of St. Louis

[36] *"A Keynesian Presentation of the Relations Among Government Deficits, Investment, Saving, and Growth,"* L. Randall Wray, Journal of Economic Issues, December 1989

Managing the Economy: Monetary and Fiscal Policy

While federal deficits contribute to the nation's wealth, it needs to be emphasized that not all deficits are in the public's interest[37]. In fact, there are two types of deficits that can be harmful to the nation:

- Deficits that exacerbate wealth inequality or that otherwise are not in the public interest (like a bridge to nowhere), and
- Deficits that result in an undesirable level of inflation.

The federal government has three entities through which it manages the economy:

- Congress, which conducts fiscal policy,
- The Federal Reserve, which conducts monetary policy, and
- The Treasury which also conducts monetary policy.[38]

Monetary and fiscal policy are powerful tools but their use can and sometimes do result in unintended or unfortunate consequences. We'll focus first on the Fed and monetary policy.

The Fed's goals are maximum employment, stable prices, and moderate long-term interest rates.[39] "Maximum employment" is defined as "the highest level of employment or lowest level of unemployment that the economy can sustain *while maintaining a stable inflation rate* (emphasis added)."[40]

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[37] Or any fiscal policy, for that matter.

[38] The Treasury is not normally seen in this role, but the Office of Debt Management, described earlier in this paper, has a distinct purpose in managing interest rates through the process of debt issuance.

[39] According to the Federal Reserve, "When prices are stable, long-term interest rates remain at moderate levels, so the goals of price stability and moderate long-term interest rates go together. As a result, the goals of maximum employment and stable prices are often referred to as the Fed's "dual mandate."'

[40] https://www.federalreserve.gov/faqs/what-economic-goals-does-federal-reserve-seek-to-achieve-through-monetary-policy.htm#:~:text=The%20Federal%20Reserve%20works%20to,moderate%20long%2Dterm%20interest%20rates.

“Stable prices” translates to a certain goal for inflation,[41] generally 2% of core personal consumption expenditures (PCE), but recently the Fed has announced a willingness to allow inflation to run higher than 2% in a form of “catch-up” to recent years when inflation has been below 2%.[42]

The Fed relies on different tools to conduct monetary policy[43] but they all have one thing in common, the control of interest rates and, as a consequence, the control of economic activity.[44]

It is important to note that the Fed does not have tools to directly affect employment but rather relies on calibrating economic activity through interest rate management to achieve its “maximum employment” objective. And therein lies one of two main problems with monetary policy.

For many years, it was believed that there was a direct relationship between inflation and employment, namely, that unemployment below a certain level led to high inflation[45]. This led to a balancing act in which activities to restrain inflation would slow economic activity and, therefore, lead to an increase in unemployment, negatively impacting the Fed’s maximum employment mandate.

More recently, the Fed has come to understand that low levels of unemployment do not necessarily lead to inflation.[46] In fact, while it is generally true that inflation is a result of too much money chasing a limited supply of resources, potentially including labor, the actual causes of inflation, especially lack thereof, during a period in a complex economy are not easily isolated or well understood.[47] Therefore, the Fed

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[41] The Fed uses core PCE for its target inflation rate.

[42] How long securities markets will “allow” the Fed to postpone reacting to inflation is unknowable.

[43] See: https://www.federalreserve.gov/aboutthefed/files/pf_complete.pdf, the latest edition being October 2016.

[44] The Fed does not control the money supply as that term is defined. Only the Congress (with the Treasury as its agent) has that ability through deficit spending and commercial banks through the process of lending.

[45] This was known as the Phillips Curve (https://www.econlib.org/library/Enc/PhillipsCurve.html).

[46] The Federal Reserve Bank of St. Louis, https://www.stlouisfed.org/open-vault/2020/january/what-is-phillips-curve-why-flattened.

[47] Ibid, https://www.stlouisfed.org/publications/regional-economist/first-quarter-2018/why-inflation-so-low.

is challenged in how to manage inflation without causing an increase in unemployment.

Despite the Fed reaching the above understanding, it is limited to the tools it has available, with the Federal Funds Rate (FFR) and open market operations as perhaps the best known and watched tools[48]. Accordingly, when the Fed assesses it is time to address inflationary pressures, it begins to increase the effective FFR[49] or sells Treasuries in open market operations to designated counterparties in exchange for reserves, both of which, in turn, are intended to lead to higher interest rates and slowing economic activity[50].

By controlling inflation through interest rate management, wide swaths of the economy are affected and the resulting impact on employment is not only indiscriminate, it disproportionately affects lower wage workers, especially people of color, increasing their unemployment at a disproportionate rate.

Fed Chair Yellen: “The rates for Hispanic or Latino workers are similarly affected (that is, rates moving in tandem but higher than the rates for all workers). Economic crises generally do this: They take pre-existing inequalities – and make them even more unequal. To me, it’s one of the most pernicious effects of a struggling economy, ….[51].”

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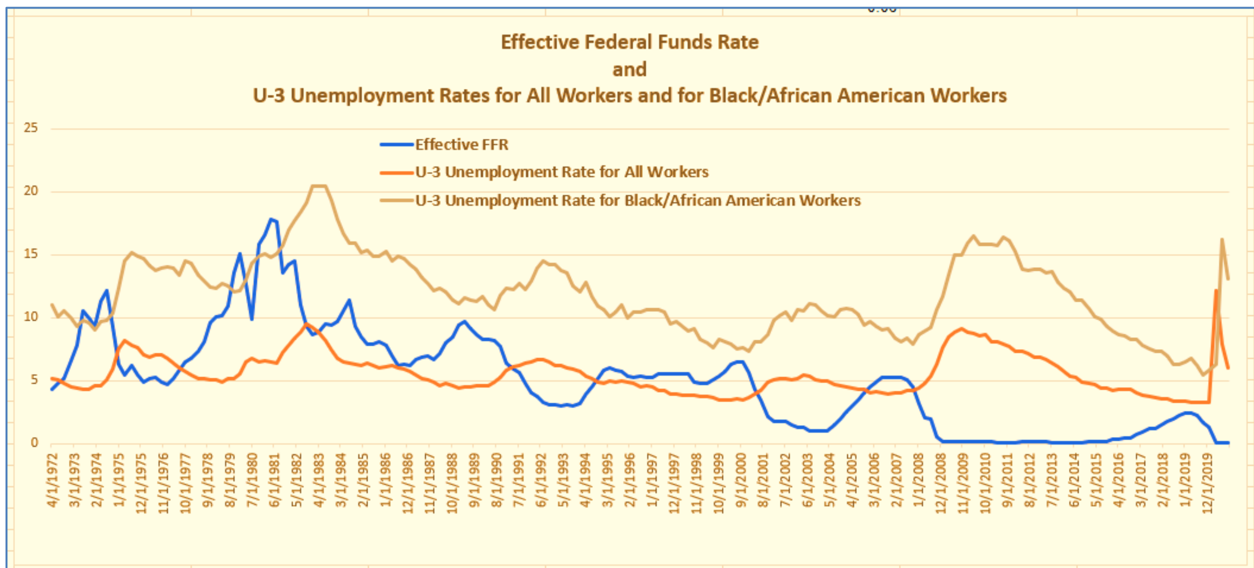
[48] The Financial Services Regulatory Relief Act of 2006 authorized the Fed to pay interest on required and excess reserves held at Reserve Banks, the purpose of which was manage the FFR without resorting to open market operations.

[49] The Fed uses open market operations on short term Treasury bills to move short term interest rates to within a range, for example, 0 to 25 basis points. Since the impact of open market operations is not precise, the actual FFR, called the “effective” FFR, ends up somewhere within the range.

[50] The actual level of rates is critically important. Rising rates in a low rate environment as exists at the time of this writing may have little or no impact on investment decisions. If anything, it may spur those decisions n anticipation of even higher long-term rates.

[51] Remarks from Secretary of the Treasury Janet L. Yellen to the U.S. Hispanic Chamber of Commerce Virtual Legislative Summit, March 30, 2021, “Each of these crises (the five major economic crises experienced by Janet Yellen since 1963) was very different, but they all shared at least one significant characteristic: They all hit Latino-Americans disproportionately hard. In fact, if you take the Hispanic unemployment rate over the past 50 years and superimpose it on top of the national average, what you see are two lines that roughly move in tandem – except the Hispanic unemployment rate is always above the national average. And when there is a crisis, both rates spike, but the Hispanic rate spikes much higher.’ https://home.treasury.gov/news/press-releases/jy0089

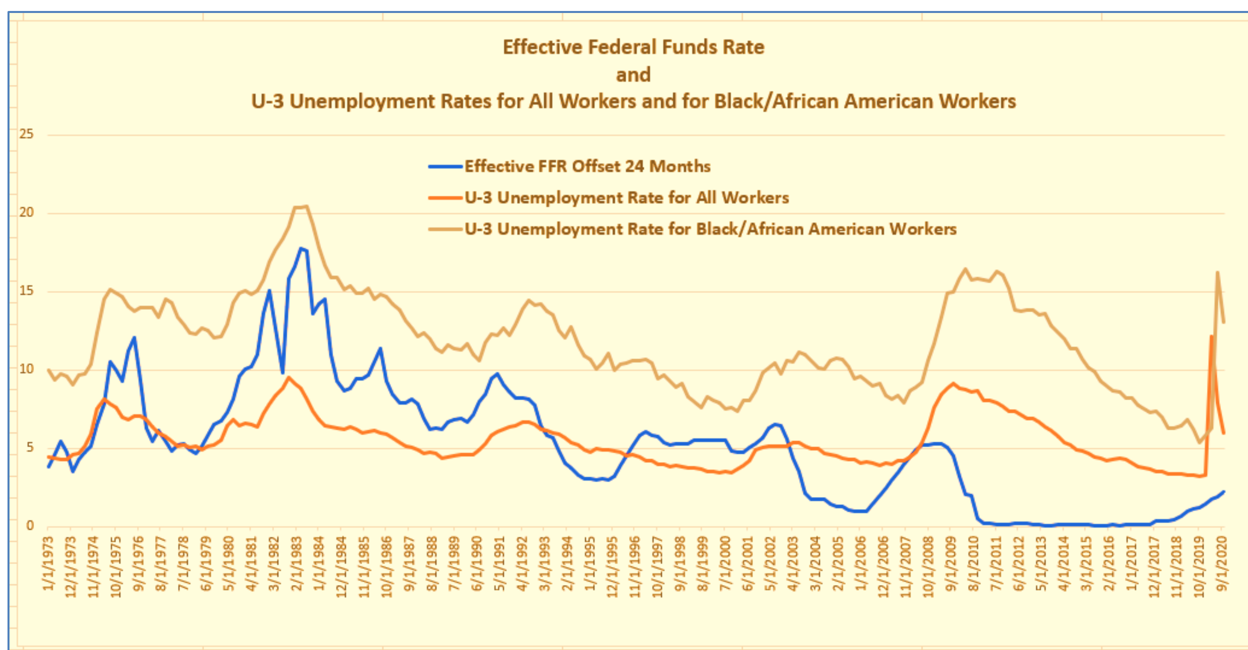
In the chart below, we see how changes in the effective FFR correspond to increases in the commonly reported U-3 unemployment rate[52] over the next 24 months or so for all workers and for Black or African American workers. In this chart, correlation between the effective FFR and the U-3 unemployment rate for Black/African American workers is .30 (author's calculation), a value not considered significant.



Source: Economic Research, Federal Reserve Bank of St. Louis

The above chart shows the FFR for the period in which it is effective while the unemployment rate relates to a prior month. To make the relationship between movement in the FFR and its impact on unemployment more clear, especially for Black or African American workers, the next chart uses the same data but shifts the effective FFR back by 24 months. With the offset in the effective FFR, the correlation between the effective FFR and U-3 for Black/African American workers increased from .30 to .60, a value considered to represent a strong correlation.

[52] The U-3 rate does not reflect underemployed and discouraged workers, thus understating the full measure of unemployment.



Source: Economic Research, Federal Reserve Bank of St. Louis

While monetary policy conducted by the Fed has serious drawbacks, a significant strength is that it is under the control of a relative few people who do not face the electoral process and who can act very quickly, when needed.

The bottom line on monetary policy is that there is an inherent conflict between managing inflation and maximizing employment[53]. Invariably, when it becomes necessary to cool down the economy through monetary policy, employment suffers and income and wealth disparity is exacerbated. To address this problem, we turn to fiscal policy as advocated by the current and former Fed Chairs[54].

Congress implements fiscal policy through taxation and spending[55] and can use both of these activities to address inflation in a highly focused

[53] Federal Reserve Chair Powell recognized the harmful effects of contractionary monetary policy on employment in a policy shift announced in August 2020 (https://www.washingtonpost.com/business/2020/08/27/powell-jackson-hole-inflation/).
[54] See: https://www.cnbc.com/2020/10/06/fed-chair-powell-calls-for-more-help-from-congress-says-theres-a-low-risk-of-overdoing-it.html, https://www.barrons.com/articles/former-fed-chairs-bernanke-and-yellen-call-for-more-fiscal-stimulus-51595016071
[55] In the form of industrial subsidies.

manner. The problem with fiscal policy is the time-consuming and difficult process to implement legislation.

Keynesian theory states that "deficits should move in a countercyclical manner to stabilize the economy."[56] In fact, today there are automatic stabilizers built into the system to address rising unemployment and exacerbated wealth inequality that don't require Congressional action, like unemployment benefits and indexed tax rates. Unfortunately, these have been proven to be inadequate to address the needs of workers who lose their jobs in a recession, especially one brought on by an event like the pandemic or jobs shipped overseas[57].

Joblessness arises from many sources, including recessions, contractionary monetary and fiscal policies, and jobs moved out of the country. In 2019, over 10% of the population lived in poverty, including nearly 12 million children.[58] Surely, the numbers are much greater today as a result of COVID-19.

It is hard to imagine something more destructive and impactful on democracy and America's future than this, not to mention the impact on America's competitiveness with China.[59]

Government has an interest in making sure that citizens do not live in poverty, especially children on account of the long-term destructive nature of childhood poverty, and to help all those who are able to work find jobs that provide an adequate standard of living and to help those who are not able to work to stay out of poverty. In fact, the Employment Act of 1946 states: "*The Congress hereby declares that it is the*

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[56] "Has Japan Been Following Modern Money Theory Without Recognizing It? No! And Yes." By L. Randall Wray and Yeva Nersisyan, http://www.levyinstitute.org/pubs/wp_985.pdf

[57] See: https://econofact.org/the-role-of-automatic-stabilizers-in-fighting-recessions and https://econofact.org/the-role-of-automatic-stabilizers-in-fighting-recessions.

[58] https://www.census.gov/newsroom/press-releases/2020/income-poverty.html and https://www.childrensdefense.org/policy/resources/soac-2020-child-poverty/#:~:text=Children%20remain%20the%20poorest%20age,and%20older%20(10%20percent).

[59] See: https://www.poorpeoplescampaign.org/resource/costs-of-poverty-fact-sheet/ , https://www.pewresearch.org/social-trends/2019/03/21/public-sees-an-america-in-decline-on-many-fronts/

continuing policy and responsibility of the Federal Government to use all practicable means…for the purpose of creating and maintaining … conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power."[60]

The 1946 Act was amended in 1978 by the Full Employment and Balanced Growth Act (also known as the Humphrey-Hawkins Act) adding, inter alia, "*the Congress further declares and establishes as a national goal the fulfillment of the right to full opportunities for useful paid employment at fair rates of compensation of all individuals able, willing, and seeking to work.*[61]"

While it is beyond the scope of this paper to provide a laundry list of ways full employment[62] be achieved, interesting ideas have been put forth by economist Pavlina Tcherneva and U.S. Representative Ayanna Pressley, among others[63].

The most important thing for any program that is meant to address poverty and unemployment is that it be beyond the reach of politics of the day by automatically matching the scope of the problem when it occurs rather than letting it fester and lead to permanent damage, not to mention potential political unrest (a recent report by the Washington Post points to a majority of those involved with the Capitol riot having a history of financial trouble.[64]) While it is understood that the mechanics of such programs could lead to benefits being distributed to those who

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[60] See: https://fraser.stlouisfed.org/title/employment-act-1946-1099#:~:text=An%20Act%20to%20Declare%20a,304%2C%2079th%20Congress%2C%20S..

[61] See: https://fraser.stlouisfed.org/title/full-employment-balanced-growth-act-humphrey-hawkins-act-1034.

[62] Full employment essentially means the elimination of all but so-called "frictional" unemployment, the unemployment that occurs as workers transition from one job to another.

[63] See: http://www.levyinstitute.org/publications/pavlina-r-tcherneva , https://njfac.org/, https://pressley.house.gov/media/press-releases/rep-pressley-economists-advocates-unveil-historic-federal-job-guarantee, https://equitablegrowth.org/improving-automatic-stabilizers-to-combat-u-s-economic-recessions/

[64] https://www.washingtonpost.com/business/2021/02/10/capitol-insurrectionists-jenna-ryan-financial-problems/

don’t deserve them, this issue can be addressed directly through subsequent taxation and other means.

No one solution will meet the needs of all those who need help in diverse areas of the country. However, Congress has an obligation to adopt automatic stabilizers of sufficient size and scope to address the most basic needs of the population. Only in this way can the nation thrive and come closer to achieving the aspirations of most Americans.

Congress can also help manage the economy by instructing the Congressional Budget Office to focus its scoring of proposed legislation on the impact on wealth redistribution, employment and inflation instead of the impact on deficits.

Summary

In this paper, we have seen:

- Federal deficits are a source of wealth creation in the United States;
- Federal taxes and government debt do not finance government spending;
- Federal debt is simply an alternative form of currency, an interest bearing one, that need not be repaid;
- Inflation and poorly directed spending or tax policies are proper concerns for fiscal policy choices;
- Monetary policy can address inflation but imposes harm on the most vulnerable citizens in doing so; and
- Fiscal policy can address shortcomings in monetary policy but only in the form of sufficient automatic stabilizers beyond the reach of temporal politics.

In the context of the extraordinarily difficult and challenging economic situation America finds itself in at the beginning of 2021, not to mention strategic challenges presented by China[65], it is critically important for lawmakers to understand the role deficits and debt truly play in the economy and how best to address economic challenges, like inflation and exacerbated wealth inequality, when they arise.

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[65] President Biden, in his press conference on March 25, 2021, remarked that the existential battle was between autocracy and democracy. Proving democracy works can only be accomplished by meeting the most basic needs of the population. See: https://www.nytimes.com/2021/03/26/us/politics/biden-china-democracy.html.