

Washington Is Quietly Repudiating Its Debts

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Will the U.S. Treasury repudiate its obligations to its creditors, be they citizens or investors around the world? Most observers would answer "no" without hesitation. But Congress, with the complicity of the White House and the Fed, has arguably embarked on a stealth repudiation.

In his famous treatise, "The Wealth of Nations," Adam Smith noted there had never been a "single instance" of sovereign debts having been repaid once "accumulated to a certain degree." We may have reached Smith's threshold.

The bond markets are certainly not protecting creditors from the risk of what Smith called "pretended payment" through inflation. Nor did they do so until far into the great inflation of the 1970s. Not until late 1977 and into 1978 did the bond market fully incorporate the reality of the debased dollar, by demanding higher long-term interest rates.

How can this happen? Markets are supposed to be forward-looking and efficiently price in all relevant risks. Yet monarchs have been repudiating debt explicitly and implicitly throughout recorded history.

Many years ago, the Austrian economist Ludwig von Mises offered an explanation. He suggested that while you can't, in Abraham Lincoln's words "fool all of the people all of the time," you can fool all of the people at least some of the time. And this is easier to do if a central bank has in the past earned credibility in fighting inflation.

In the 1980s, Ronald Reagan and Paul Volcker worked together to get inflation under control. They were greatly assisted by the "bond vigilantes," traders who were by then exerting discipline in bond markets by bidding up interest rates to double-digit levels. The outcome of the Reagan/Volcker policy of tight money and low marginal tax rates was not only a great economic expansion, but also a great boost to the Fed's credibility. The Fed proved it was able and willing to withstand political heat in the fight against inflation.

Alan Greenspan built on the Volcker legacy and, at least in the early years of his long tenure, continued the fight against inflation. In the 1990s, when Mr. Greenspan faced his own banking crisis, he was able to adopt a policy of comparatively low short-term interest rates. Banks used the opportunity to borrow cheaply and lend profitably to grow their way out of the crisis. Credibility allowed the Fed to engineer a recovery without stoking inflation fears.

After the collapse of the dot-com bubble in 2000, and then 9/11 and its aftermath, Mr. Greenspan again relied on the Fed's credibility to drive down the federal-funds rate to 1% and then hold it there for a year. This time there was a rumbling of doubts. But eventually the Fed did reverse course to preserve its inflation-fighting credentials, and briefly hiked the federal-funds rate to over 5%.

Now Fed Chairman Ben Bernanke has decided to try for a hat trick, and spend the Fed's reputational capital on an easy credit policy. He is doing so under considerably more adverse circumstances than his two predecessors.

Thanks to Reagan and Volcker -- and the credibility he built up on his own early on -- Mr. Greenspan did not face strong inflationary forces in the 1990s. But Mr. Bernanke began his easy money policy with inflation already picking up steam. Worse, we have the accumulated effects of seven years of loose fiscal policy.

Yes, we had the Bush tax cuts, but their beneficial, growth-enhancing effects have long since been swamped by an explosion of government spending. As Milton Friedman long ago taught us, government spending is the ultimate tax on the economy: It extracts real resources from productive, private use and puts them to unproductive, public use. And there is the rub.

Not even a President Obama and a Congress controlled by House Speaker Pelosi and Senate Majority Leader Reid is going to hike taxes enough to pay for all their spending. Indeed, they have shown themselves quite unwilling to engage in honest budgeting. The best example is saddling Fannie Mae and Freddie Mac with \$500 million of new (off-budget) obligations to fund cheap housing at a time when the two companies were already on the ropes. Is it any wonder the stock prices of these two companies are imploding?

The markets have long assessed the debt of Fannie and Freddie at AAA because of the Treasury's guarantee, now explicit. But no one has ever seriously assessed the Treasury's creditworthiness with Fannie and Freddie on its books. The public guarantee is entirely open-ended and unbounded. The appetite of the two companies to balloon their balance sheets and take on risk has not been curtailed. Meanwhile, Congress spends apace with new programs for constituents in an election year.



We are at a Smithian moment, in which the temptation for the Fed to spend its last dime of credibility may prove irresistible. Investors are already being taxed by inflation and can rationally expect that tax rate (the inflation rate) to be raised going forward. Wages are not keeping up. Main Street is being taxed to fund Wall Street excess. Anyone who works, saves and invests is exposed to confiscation of his capital and earnings through inflation.

If the Fed maintained its independence of action and said no to the inflationary finance of Congress's profligacy, we wouldn't have reached this point. But the Fed has forsaken that independence amid an absence of leadership.

Perhaps, as rarely happens, Adam Smith will be proven wrong. Let us hope so, because hope appears to be all we have.