Ambiguity in American Monetary and Fiscal Policy

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> "Experience shows that what happens is always the thing against which one has not made provision in advance." Letter from John Maynard Keynes to Jacob Viner.
>
> $(\Omega, F, \mathcal{P})$, or $(\Omega, F, ?)$, or $(?, ?, ?)$?

1 Prevailing notions of equilibrium

All modern models of fiscal and monetary policy describe monetary fiscal policy by strategy profiles that spell out policy actions as functions of histories of information available to policy makers at each date. Models differ in what determines those strategies, but the rational expectations equilibrium concept common to all of our models requires such a complete description of monetary and fiscal policies. We are all familiar with different ways that such government strategies are specified in the literature: either as (1) as exogenous state contingent rules; or (2) as (time-inconsistent) time 0 solutions of Ramsey problems; or (3) as (time-consistent) Markov-perfect equilibria of a policy game played by a sequence of governments, solved by backward induction; or (4) as outcomes of recursive political-economic equilibria designed to capture the sequential interactions of successive generations of voters, and again solved by backward induction.

All of these settings share the feature that an agent living within one of these models would know the monetary and fiscal policies affecting him. In some models, he might not like those policies; but he would be sure about what those history-contingent strategies are. In random dynamic models, he would face uncertainty about future policy *actions*, but only because the future events conditioning the policy are yet to be realized, not because the strategy describing policy is incomplete or ambiguous. He would face no *ambiguity* or *Knightian uncertainty* about those policies.

*(New York University and Hoover Institution (email: thomas.sargent@nyu.edu). This is the text for a lunch time talk at the conference sponsored by the Japan center in April 20004. The epigraph from Keynes to Viner is cited in the third volume of Robert Skidelsky's biography of Keynes. The other epigraph is just a modern way of phrasing Keynes's remark to Viner. The quotations are from Dewey's book.

2 The U.S. Today

Do U.S. citizens today confront known fiscal and monetary and fiscal policies? Perhaps, but if so, they are not ones that can be gleaned from existing laws, administrative rulings, or political party platforms. In terms of status quo legislation and existing paper or electronic descriptions of it, American fiscal policy today is unsustainable or "incoherent". Experts tell us that status quo structures of sequences of entitlements, and of tax rates are unsustainable and not regarded by no one as *forecasts* of future outcomes. As examples, take the alternative minimum tax, whose impact is scheduled to grow, and the inheritance tax, which is scheduled to expire, then jump to its level in 2000. Such examples proliferate when we consider Medicare and Medicaid.

Of course, the government budget constraint assures us that *actual* fiscal policy will be sustainable. What we do not know today is *how* subsequent political deliberations from shifting majority coalitions will render U.S. fiscal policy coherent.

Of course, monetary policy cannot be coherent unless fiscal policy is. Although the U.S. celebrates its tradition of having been created as a 'government of laws, not of men,' we have a monetary policy that is the most discretionary of any major western country today! Until now, the FOMC has preferred not to be tied down to an inflation target (and maybe it would even be illegal for them to do so because of the Full Employment Act of 1948 and the Humphrey-Hawkins Act). Meanwhile, inflation targeting prevails in Europe. Even more, most European countries have surrendered monetary sovereignty, eloquent testimony to how seriously *they* take the temptation to inflate.

2.1 Ambiguity in U.S. fiscal policy is nothing new

U.S. financial history reveals that ambiguity has pervaded our monetary and fiscal policy since before our Republic was founded. Let me take one theme that ran through U.S. monetary history from before Yorktown to when President Nixon closed the gold window. Should the U.S. government issue paper money?

3 Ambiguity in American Fiscal and Monetary History

3.1 Ideas of Kydland and Prescott at the Constitutional Convention

The American revolution was financed mainly by issues of paper money and interest bearing debt by the 13 colonies and the continental congress. Paper monies were known euphemistically as 'bills of credit'. So much paper money was issued that the price level seems to have tripled. So much interest bearing debt was issued that markets discounted it heavily vis a vis specie. The drafters of the Constitution and their supporters hated paper money and the dismal state to which it had reduced American credit. That attitude set the stage for a debate at the constitutional convention about the powers over monetary policy to assign

to the state and federal governments. The delegates to the convention quickly agreed to prohibit state governments from issuing bills of credit. Despite their hatred of paper money, on the morning of August 16, 1787 the prevailing draft of the Constitution nevertheless awarded the *Federal* government the authority to borrow “and emit bills on the credit of the U. States’, even though emitting paper money by states was expressly prohibited. On August 16, Madison’s notes record contributions to a debate about a motion to strike out the clause giving the federal government the authority to issue bills of credit. The debate shifted to a contest between those who wanted to strike out the clause with those who wanted to go further and by *prohibiting* the federal government from issuing bills of credit.

It is interesting to read the following excerpts from Madison’s notes in light of Keynes’ message to Viner cited above and the lessons of Kydland and Prescott’s 1977 paper on time consistency.[1]

In convention, August 16, 1787:

Mr. Govr. MORRIS moved to strike out ”and emit bills on the credit of the U. States”- If the United States had credit such bills would be unnecessary: if they had not, unjust & useless.

Mr. BUTLER, 2ds. the motion.

Mr. MADISON, will it not be sufficient to prohibit the making them a *[legal] tender*? This will remove the temptation to emit them with unjust views. And promissory notes in that shape may in some emergencies be best.

Mr. Govr. MORRIS. striking out the words will leave room still for notes of a responsible minister which will do all the good without the mischief. The Monied interest will oppose the plan of Government, if paper emissions be not prohibited.

Col. [FN20] MASON had doubts on the subject. Congs. he thought would not have the power unless it were expressed. Though he had a mortal hatred to paper money, yet *as he could not foresee all emergences, he was unwilling to tie the hands of the Legislature.* He observed that the late war could not have been carried on, had such a prohibition existed.
For explicit prohibition

Mr. ELSEWORTH thought this a favorable moment to shut and bar the door against paper money. The mischiefs of the various experiments which had been made, were now fresh in the public mind and had excited the disgust of all the respectable part of America. By withholding the power from the new Governt. more friends of influence would be gained to it than by almost any thing else. Paper money can in no case be necessary. Give the Government credit, and other resources will offer. The power may do harm, never good.

Mr. RANDOLPH, notwithstanding his antipathy to paper money, could not agree to strike out the words, as *he could not foresee all the occasions which [FN21] might arise.*

Mr. WILSON. It will have a most salutary influence on the credit of the U. States to remove the possibility of paper money. This expedient can never succeed whilst its mischiefs are remembered, and as long as it can be resorted to, it will be a bar to other resources. Mr. MASON was still averse to tying the hands of the Legislature altogether. If there was

[1]You can find Madison’s notes on the Yale Law School’s web site.

no example in Europe as just remarked, it might be observed on the other side, that there was none in which the Government was restrained on this head. Mr. READ, thought the words, if not struck out, would be as alarming as the mark of the Beast in Revelations. Mr. LANGDON had rather reject the whole plan than retain the three words "(and emit bills")

On the motion for striking out

N. H. ay. Mas. ay. Ct ay. N. J. no. Pa. ay. Del. ay. Md. no. Va. ay. [FN23] N. C. ay. S. C. ay. Geo. ay.

Thus, the motion to strike carried 8 states to 2, but the framers stopped short of explicitly prohibiting the federal government from issuing bills of credit.

3.2 Ambiguity in Civil War Fiscal Policy

The Republican party that came to power in 1860 was formed from remnants of the Whig Party that hard money Jackson democrats had long regarded as soft on paper money. Did this reputation impart a credibility problem to the new Lincoln administration? Probably not, because, perhaps anticipating Kenneth Rogoff's idea that a way to moderate a temptation to inflate is strategically to delegate monetary authority to an inflation hawk, Lincoln appointed as his Secretary of Treasury Samuel Chase, governor of Ohio, a former Jackson hard money democrat, and a future Chief Justice of the U.S. Supreme who would declare unconstitutional Congress's 1863 action of awarded legal tender status to the greenbacks that Chase as secretary of treasury issued to help finance the war.

- The Union issued greenbacks. In 1863, Congress made them legal tender for all debts public and private, *except* payment of customs duties, the lion's share of Federal Revenues. The legal tender clause created many winners and losers. A market for exchanging gold dollars for greenbacks quickly emerged. Greenbacks went at discounts whose depth varied inversely with the success of Union armies. By the end of the war they were worth 40 or 50 cents in gold.

- In those days, the Congress itself designed Federal securities. In 1863, the Congress authorized the Treasury to sell "5-20's". They were redeemable in twenty years, but callable at par at the government's discretion in 5 years. (In effect, the Union government simultaneously borrowed and purchased a call option.) The 5-20's bonds promised to pay interest in gold, but were silent about whether the principle would be payable in greenbacks or in gold.

- Despite the Congress's silence about whether the principal was payable in greenbacks or gold, Secretary Chase had advertised the loans would be repaid entirely in coin.

- The ambiguity about the currency in terms of which the 5-20's would be repaid was resolved by a political debate after the war.

3.3 Outcomes and the emergence of policies

Prices denominated in greenbacks doubled during the civil war, then receded enough during the next 1879 to permit the U.S. to resume specie payments, de facto making a greenback a warehouse certificate for a quantity of gold. of prices. If you seek a clear statement of U.S. fiscal and monetary policy in the laws, you won't find it. It emerged gradually. The U.S. did not formally fully articulate its commitment to a gold standard until 1900.

The ambiguity with which the loose ends in Union fiscal policy confronted market participants came in for ample criticism. Chase's successor as secretary of Treasury acknowledged the disorder in fiscal and monetary policy and apologized it with an appeal for understanding that conjures up Mason's argument from August 16, 1787:

> "It is, in the secretary's judgment, not only difficult but impossible to apply fixed rules to a condition of affairs constantly changing, or to meet contingencies which no human reason can foresee by a steady application of general laws, especially in a government and with a people where public opinion is the controlling element, and that opinion is not under the direction of those who may happen to administer public affairs." Secretary of Treasury Fessenden, Dec. 1864.

Secretary Fessenden's vision of the situation imputes more imperfections and ambiguities to the situation than seems captured by the strategy profiles for fiscal policy that are in our models.

The ambiguity about how the principal in the 5-20's and other bonds would be repaid was resolved by subsequent Congresses and administrations. A pointed debate about whether to repay with greenbacks or specie emerged. President Johnson and leading democrats advocated repaying the principal in greenbacks.

> "The lessons of the past admonish the lender that it is not well to be over-anxious in exacting from the borrower rigid compliance the letter of the bond." President Andrew Johnson (p. 346 in Dewey).

Obviously, Johnson did not understand his duty as requiring him to preside over a branch of a Lucas-Stokey optimal debt-management policy that rewarded owners of government debt with large state-contingent returns when government spending had receded after the War. Of course, Johnson could not have known about Lucas and Stokey's advice, but he surely knew about Alexander Hamilton's. Although Johnson turned his back on Hamilton's policies, his successor Ulysses S. Grant did not. In his inaugural address in March 1869, Grant promised repayment in gold unless otherwise stipulated.

> "A great debt has been contracted in securing to us and our posterity the Union. The payment of this, principal and interest, as well as the return to a specie basis as soon as it can be accomplished without material detriment to the debtor class

or to the country at large, must be provided for. To protect the national honor, every dollar of Government indebtedness should be paid in gold, unless otherwise expressly stipulated in the contract. Let it be understood that no repudiator of one farthing of our public debt will be trusted in public place, and it will go far toward strengthening a credit which ought to be the best in the world, and will ultimately enable us to replace the debt with bonds bearing less interest than we now pay." U. S. Grant, first inaugural address.

Grant's recommendation ultimately prevailed. But when he spoke, substantial ambiguity was still to characterize U.S. policy about whether and how to implement his recommendation. The years from 1869 to 1900 contain a succession of Congressional and administrative actions that put the U.S. formally on a gold standard for 33 years, from 1900 to 1933, and less formally before that from 1879 to 1900. The Congressional legislation and Treasury administrative decisions that ultimately produced these outcomes emerged gradually out of a sequence of decisions about fiscal policy that were at the times criticized because they rendered status quo U.S. fiscal and monetary policy unsustainable. You can find fresh accounts of these measures in the books by Alfred Noyes and Davis Dewey.

Some significant events in this process were:

- 1873. In legislation that was later labelled 'the Crime of '73' by many Congress gold dollar declared the standard.

- 1878 and 1890 Bland-Allison and Sherman Acts require or authorize the U.S. Treasury to purchase silver and to issue silver certificates called dollars. The legislation left open whether silver certificates were convertible into gold. The Sherman act delegated that decision to the secretary of the Treasury. In fact, successive secretaries did redeem them. Could they have chosen otherwise?

- The substantial outstanding stocks of silver certificates, contributed to a sequence of runs on gold in the 1890s, each of which was stemmed only when the U.S. Treasury borrowed gold to support the dollar.

- 1896: the U.S. presidential election was fought mainly on the Democrat Bryan's proposal that the U.S. freely coin silver at a ratio of 16/1 at a time when the market price ratio was about 30/1. Bryan loses. Gold discoveries and new technologies for extracting gold cause the price of gold to begin falling.

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- In 1900, legislation was passed to make U.S. dollars payable in gold.

- In 1933, Congress repealed the gold clause, thereby abrogating contracts promising repayment in gold. The U.S. supreme court ultimately upholds this legislation.

4 Concluding remarks

Are U.S. fiscal and monetary policy more ambiguous than they were, say, in 1865? Probably, because the political consensus that deficits are bad seems weaker than it was a century ago?[2] Do I have predictions to offer about how these ambiguities will be resolved? No. Is it likely that macroeconomic theory will soon present us with tools for analyzing such monetary and fiscal ambiguities and how they are to be resolved? I do not know.

References

Dewey, Davis R., 1912, *Financial History of the United States*, 4th ed. New York, Longmans, Green, and Co.

Noyes, Alexander Dana, 1898, *Thirty Years of American Financial History*, New York, London, G.P. Putnam's sons.

[2]Secretary Oneil was told that 'Reagan proved that deficits don't matter.' Would sentiments like that have been expressed by either party a century ago?