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Former Fed Economist Arnold Kling comments on interest, Ben Bernanke to deliver testimony

By: Andrew Moran - February 26, 2013

Arnold Kling, a former economist at the Federal Reserve from 1980 to 1986, published a blog post over the weekend that looked at economist Tyler Cowen's remarks on the Fed and inflation levels. Here are Cowen's initial comments:

"Everything we were taught about the monetary base is wrong in a world with interest on reserves (IOR). A large base can sit there forever. The price level is not proportional to the base, changes in the base, etc. It just isn't. The broader aggregates, such as M2, haven't grown so rapidly."

Kling puts forth a scenario that "worries" him: the United States national debt continues to rise, interest rates go up, the federal government borrows more money and the Fed is asked to do something to ease the pain.

Tyler noted that the Fed could purchase Treasuries without leading to a boost in the money supply (inflation), but Kling stated that the only way to do this is to raise the interest rate that it doles out on reserves. Kling concluded that this method does not solve the issue to decrease the government's interest costs.

"My guess is that in practice, for a variety of reasons, when the cost of government debt starts to rise, the Fed is not going to be willing/able to sterilize its funding of the debt, through IOR or any other means," stated Kling, an Adjunct Scholar at the Cato Institute. "We are going to see both intended and unintended monetary expansion, and that will produce inflation. As usual, let me say that I am not blaming the Fed or saying that inflation is just around the corner. When really out-of-control inflation emerges, it is a fiscal phenomenon."

When it comes to interest rates, the Fed Chairman Ben Bernanke has said that he will lower rates only if the unemployment rate gets to 6.5 percent, but it only depends on how it gets there. This means that rates won't even go down if the jobless figures decrease due to an exodus of workers out of the marketplace.

In regards to Fed actions, Economic Collapse News reported that some members of the Fed's 12-member committee are cautious about any further action taken by the central bank and if its policies that have been instituted are actually doing more harm than good.

The Fed is increasing its balance sheet by a $1 trillion this year as it will purchase $85 billion each month of Treasury securities and mortgage-backed securities for an indefinite period of time.

Bernanke will begin his two-day congressional testimony Tuesday and every investor will be sure to hang onto his every word. His prepared testimony was released Tuesday morning (click here for his semiannual monetary policy report to the Congress).

It is likely that he will criticize the federal government's sequester that will lead to across-the-board cuts, but still increase the national debt in the long-term. Bernanke will repeat his assertions that any budget cuts will hurt the recovery and it would be a better policy of cutting the budget deficit over a longer period of time and avoid the risk of short-term fiscal shock.

"To address both the near- and longer-term issues, the Congress and the Administration should consider replacing the sharp, frontloaded spending cuts required by the sequestration with policies that reduce the federal deficit more gradually in the near term but more substantially in the longer run," stated Bernanke in his prepared remarks. "Such an approach could lessen the near-term fiscal headwinds facing the recovery while more effectively addressing the longer-term imbalances in the federal budget."