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The Fed Can't Save Us

ROBERT MURPHY ON
THE LIMITS OF MONETARY POLICY

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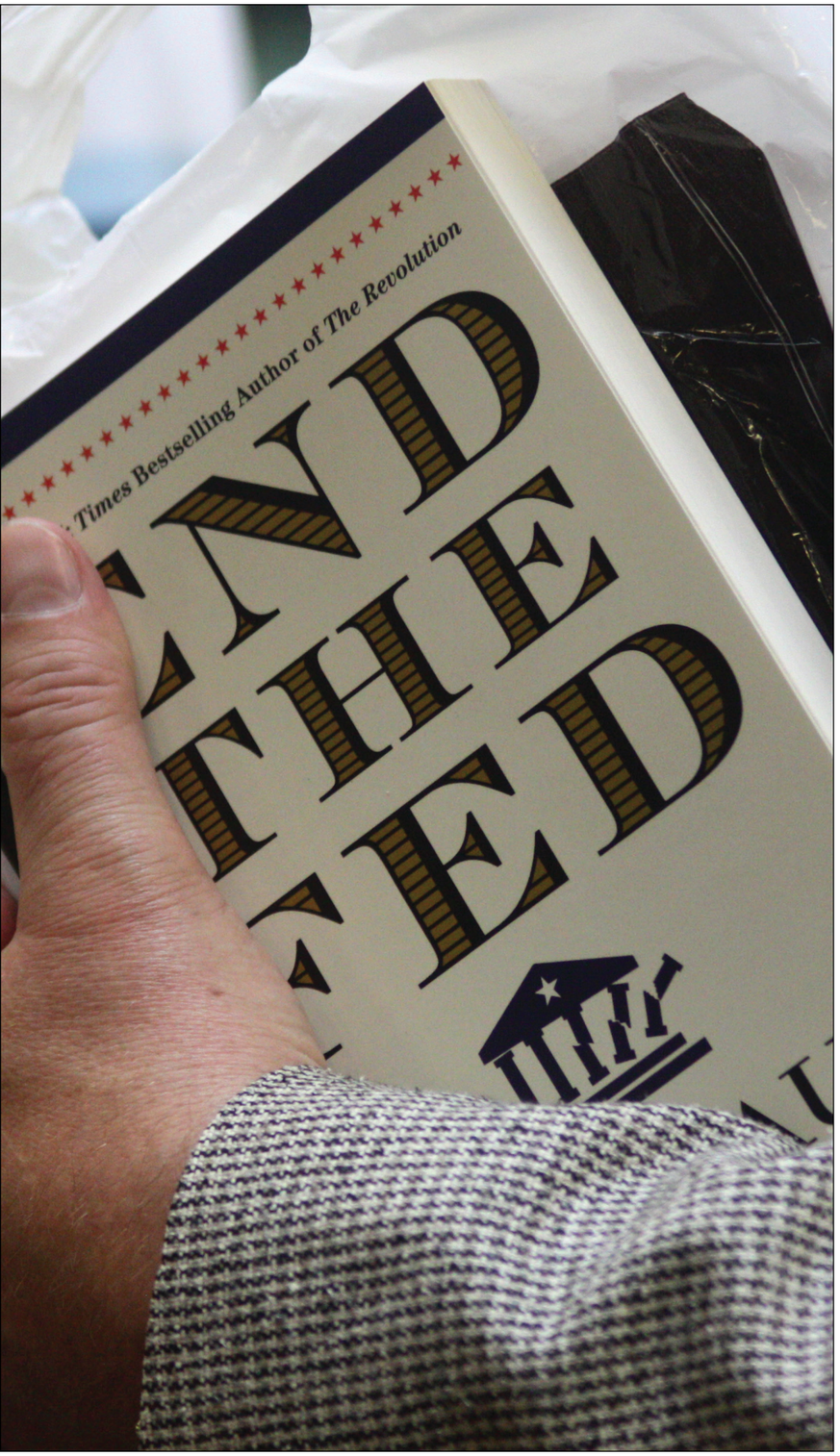

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From the publisher

Jeff Deist

Will 2016 be the year the Fed finally loses control over monetary policy?

By "lose control," we don't mean that Janet Yellen has run out of options. She and the other Fed governors can, at least in theory, engage in endless future rounds of quantitative easing and push the federal funds rate into negative territory. They can continue to fight their greatest fear — deflation — with loose monetary policy.

But they are losing control over the narrative. Even the cheerleading financial press has grown dubious of the Fed's official line that this new era of "extraordinary" monetary policy is temporary. The public, particularly investors, is beginning to realize that gains in stock market and housing prices since the Crash of '08 are artificial, supported only by the Fed's relentless determination to use monetary policy as a tool to stimulate demand.

Janet Yellen's decision last fall to increase the federal funds rate by a token 25 basis points was enough to cause former Treasury Secretary Lawrence Summers to issue dire warnings that the economy could not withstand such a move. Since then, the Dow and S&P 500 indices fell roughly 8 percent in January alone. Oil and other raw commodities have dropped. Business investment and commercial building are down. GDP, even as measured by the Treasury Department's flawed (i.e., overstated) process, grew by a mere .7 percent in the last quarter of 2015.

It is becoming more and more apparent that economic growth in the US is an illusion. US equity and bond markets, US companies, and US consumers have all become addicted to the drug peddled by the Fed.

But demand is not production. At some point real increases in profits, savings, productivity, and capital investment are needed to grow an economy. Yet with both US companies and households once again adding debt to their balance sheets, it's apparent that the fundamentals don't add up.

As Dr. Robert Murphy explains in our cover story, the Fed hardly can save us from the dilemma it created. Ms. Yellen faces a thorny proposition: she can tighten monetary policy to unwind the asset bubbles her predecessor Ben Bernanke created, and risk crashing equity and housing markets; or she can continue propping up asset markets and risk creating a bigger and more painful correction down the road. Based on everything we know about how bureaucrats respond to incentives, we can only assume she will choose to kick the can down the road as long as possible.

Also in this issue, Dr. Joe Salerno challenges the long-standing idea that the Fed operates — or should operate — with complete independence. In fact, Salerno argues, it is precisely the Fed's lack of legislative oversight or market accountability that makes it so dangerous. Why should Americans accept a system of central banking that grants almost unlimited decision making to a "clique of unaccountable Fed bureaucrats"? And why should Americans accept an arcane and opaque process of monetary expansion that seems purposely designed to obscure what the Fed is doing?

This process — a circuitous journey involving issuance of Treasury debt, purchase of said debt by commercial banks, and eventual repurchase by the Fed via its open market operations — camouflages the monetization of federal debt and gives Congress the unholy ability to spend more than it can tax or borrow. It enriches the so-called "primary dealers," the group of Wall Street firms who do business directly with the Fed and the Treasury department. It benefits particular companies and industries that receive newly created money earlier in the cycle, before general prices have begun to rise. And it distorts the entire economy by keeping interest rates artificially low and promoting malinvestment.

While Dr. Salerno obviously disagrees with central banking in general, his proposal for a system with greater transparency might surprise you.

We hope you enjoy *The Austrian*, and we hope to see you in 2016 at one of our upcoming events in Auburn, Seattle, Asheville, Dallas, or Boston. And as always, thank you for being a Mises Institute member.

Jeff Deist is president of the Mises Institute.

The Fed Can't Save Us

by Robert P. Murphy

In December, the Fed hiked its target for the federal funds rate, which is the interest rate banks charge each other for overnight loans of reserves. Since 2008 the Fed's target for the Fed Funds Rate had been a range of 0 percent – 0.25 percent (or what is referred to as zero to 25 "basis points"). But last month they moved that target range up to 0.25 – 0.50 percent. Ending a seven-year period of effectively zero percent interest rates.

From our vantage point, we already see carnage in the financial markets, with the worst opening week in US history. This of course lines up neatly with standard Austrian business cycle theory, which says that the central bank can give an appearance of prosperity for a while with cheap credit, but that this only sets the economy up for a crash once rates begin rising.

This article is adapted from a talk presented at the 2016 Houston Mises Circle.

However, there is something new in the present cycle. The Fed is trying to raise rates while simultaneously maintaining its bloated balance sheet. It is attempting to pull off a magic trick whereby it can keep all of the "benefits" of its earlier rounds of monetary expansion (i.e., "quantitative easing" or "QE") while removing the artificial stimulus of ultra-low interest rates. As we'll see, this attempt will not end well, for the Fed officials or for the rest of us. In the meantime, Ben Bernanke will look on with concern, writing the occasional blog post and perhaps giving a speech about poor Janet Yellen's tough predicament.

Austrian Business Cycle Theory

One of the seminal contributions of Ludwig von Mises was what he called the circulation credit theory of the trade cycle. In our times, we simply call it Austrian business cycle theory, sometimes abbreviated as ABCT. The Misesian theory was subsequently elaborated by Friedrich Hayek, and it was partly for this work that Hayek won the Nobel Prize in 1974.

In the Mises/Hayek view, interest rates are market prices that perform a definite social function. They communicate vital information about consumer preferences regarding the timing of consumption. Entrepreneurs must decide which projects to start, and they can be of varying length. Intuitively, a high interest rate is a signal that consumers are "impatient," meaning that entrepreneurs should not tie resources up in long projects unless there are large gains to be had in output from the delay. On the other hand, a low interest rate reduces the penalty on longer investments, and thus acts as a green light to tie capital up in lengthy projects.

So long as the interest rate is set by genuine market forces, it gives the correct guidance to entrepreneurs. If consumers are willing to defer immediate gratification, they save large amounts of their income, and this pushes down interest rates. The high savings frees up real resources from current consumption — things like restaurants and movie theaters — and allows more factories and oil wells to be developed.

However, if the interest rate drops not because of genuine saving, but instead because the central bank electronically buys assets with money created "out of thin air," then entrepreneurs are given a false signal. They go ahead and take out loans at the artificially cheap rate, but now society embarks on an unsustainable trajectory. It is physically impossible for all of the entrepreneurs to complete the long-term projects they begin.

In the beginning, the unsustainable expansion appears prosperous. Every industry is growing, trying to bid away workers and other resources from each other. Wages and commodity prices shoot up; unemployment and spare capacity drop. The economy is humming, and the citizens are happy.

> The Fed is trying to raise rates while simultaneously maintaining its bloated balance sheet.

Yet it all must come crashing down. In a typical cycle, price inflation eventually rises to the level that the banks become nervous. They halt their credit expansion, allowing interest rates to start rising to a more correct level. The tightening in the credit markets causes pain initially for the most leveraged operations, but gradually more and more businesses are in trouble. A wave of layoffs ensues, with large numbers of entrepreneurs suddenly realizing they were too ambitious. The painful "bust," or recession, sets in.

This Time Is Different (Sort of)

Since the financial crisis of 2008, the stock market's surges have coincided with rounds of QE, and the market has faltered whenever the expansion came to a temporary halt. The sharp sell-off in August 2015 occurred when investors thought the first rate hike was imminent (it had been scheduled for September 2015). That particular hike was postponed, but after it went into effect in December, we soon saw the market tank to 2014 levels.

As we would expect in times of Fed tightening, the official monetary base

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ROBERT P. MURPHY, CONTINUED

has fallen sharply in recent months, but this doesn't mean that the Fed is selling off assets (as it would in a textbook tightening cycle). Indeed the Fed's assets have been constant since the end of the so-called taper in late 2014.

This is unusual since the monetary base and the Fed's total assets typically move in tandem. Yet since late 2014, there have been three major drops in the monetary base that occurred while the Fed was dutifully rolling over its holdings of mortgage-backed securities and Treasuries, keeping its total assets at a steady level.

The explanation is that the Fed has been testing out new techniques to temporarily suck reserves out of the banking system, while not reducing its total asset holdings.

Meanwhile, the Fed in December bumped up the interest rate that it pays to commercial banks for keeping their reserves parked at the Fed. I like to describe this policy as the Fed paying banks to not make loans to their customers.

What Does It All Mean?

So why is the Fed trying to tighten the money supply without selling off assets as it has done in the past? It boils down to this: In order to bail out the commercial and investment banks — at least the ones who were in good standing with DC officials —as well as greasing the wheels for the federal government to run trillion-dollar deficits, the Federal Reserve in late 2008 began buying trillions of dollars worth of Treasury debt and mortgage-backed securities (MBS). This flooded the banking system with trillions of dollars of reserves, and went hand in hand with a collapse of short-term interest rates to basically zero percent.

Now, the Fed wants to begin raising rates (albeit modestly), but it doesn't want to sell off its Treasury or MBS holdings, for fear that this would cause a spike in Uncle Sam's borrowing costs and/or crash the housing sector. So the Fed has increased the amount that it is paying commercial banks to keep their reserves with the Fed (rather than lending them out to customers), and — for those institutions that are not legally eligible for such a policy — the Fed is effectively paying to borrow the reserves itself. By adjusting the interest rate the Fed pays on such transactions, the Fed can move the floor on all interest rates up. No institution would lend to a private sector party at less than it can get from the Fed, since the Fed can create dollars at will and is thus the safest place to park or lend reserves.

We thus have the worst of both worlds. We still get the economic effects of "tighter monetary policy," because the price of credit is rising as it would in a normal Fed tightening. Yet we don't get the benefit of a smaller Fed footprint and a return of assets to the private sector. Instead, the US taxpayer is ultimately paying subsidies to lending institutions to induce them to charge more for loans, while the big banks and Treasury still benefit from the effective bailout they've been getting for years.

It Can't Last

Will the Fed be able to keep the game going? In a word, no. We've already seen that even the tiniest of interest rate hikes has gone hand in hand with a huge drop in the markets. Furthermore, the Fed's subsidies to the banks are now on the order of $11 billion annually, but if they want to raise the fed funds rate to, say, 2 percent, then the annual payment would swell to more than $40 billion. That is "real money" in the sense that the Fed's excess earnings would otherwise be remitted to the Treasury. Therefore, for a given level of federal spending and tax receipts, increased payments to the bankers implies an increased federal budget deficit.

Janet Yellen and her colleagues are stuck with a giant asset bubble that her predecessor inflated. If they begin another round of asset purchases, they might postpone the crash, but only by making the subsequent reckoning that much more painful.

You don't make the country richer by printing money out of thin air, especially when you then give it to the government and Wall Street. The Fed's magic trick of raising interest rates without selling assets can't evade that basic reality.

Robert P. Murphy is research assistant professor at Texas Tech University, and an Associated Scholar of the Mises Institute.

The Mises Circle in Houston

The Mises Institute was back in Houston on January 30 this year for the first Mises Circle of the year. The lineup featured Ron Paul, Lew Rockwell, Bob Murphy, and Jeff Deist who were joined by over 300 attendees from 18 states.

Thanks to Mises Donors, 74 students were provided scholarships to attend from 28 colleges, universities, high schools, and home schools.

Hundreds more joined us online by watching the Mises Institute's live streaming broadcast of the event. Both in-person attendees and online participants were able to submit questions to speakers. Lectures will also be made available permanently at mises.org.

Special thanks to Christopher Condon, TJ and Ida Goss, the late Terence Murphree, and an Anonymous Donor for making this event possible.

This year's Houston Mises Circle was just the first of several planned for this year. The next Mises Circle is scheduled for May 21 in Seattle, Washington.

For more details about all our events go to mises.org/events.

JOSEPH T. SALERNO

A Modest Proposal to End Fed Independence

During the period 1980s and 1990s, the desirability of the "independence from politics" of central banks became almost an article of faith among mainstream macroeconomists and those operating in financial markets. This development was driven by two factors: academic research on central banking; and the personality cults that grew up around the two Fed Chairmen during this period, Paul Volcker and Alan Greenspan.

In the decade leading up to the financial crisis, the intellectual climate was such that anyone suggesting that the Fed have its independence curtailed or even abrogated by Congress would have been considered beyond the pale of rational, let alone scholarly, discussion. However, as the painful and protracted recovery from the Great Recession has dragged on, the Fed's independence of "politics," i.e., of legislative oversight and constraint, has begun to be challenged even by economists and financial pundits.

Few of the recent proposals to curb the Fed's independence mentioned envision fundamental institutional reform of the way in which base money is supplied under our current fiat-dollar regime.

One such reform would involve wresting control of the money supply away from the unelected technocrats at the Fed and returning it to Congress and the Treasury. In fact this reform was put forward during the controversy over raising the debt ceiling in 2013.

It is important to note that this blueprint for monetary reform closely approximates — in its fundamentals if not in its aim or sophistication — the monetary and fiscal framework that Milton Friedman proposed in 1948. The monetary component of the proposal focused on eliminating "both the private creation or destruction of money and the discretionary control of the quantity of money by central-bank authority." The first goal would be attained by implementing Henry Simon's "Chicago Plan" for 100 percent reserve banking. Friedman maintained that the second objective could be achieved by eliminating the issue of interest-bearing government securities to the public, thereby restricting the financing of government spending to taxation and money creation. Thus, as Friedman pointed out: "Deficits or surpluses in the government budget would be reflected dollar for dollar in changes in the quantity of money; and, conversely, the quantity of money would change only as a result of deficits or surpluses."

A common objection to such a proposal is that if money were under the control of the Treasury, monetary policy would become a political football and inflation would run rampant. But how much more inflationary would monetary policy become than it is right now? The unaccountable bureaucrats at the Fed have fastened on the US economy a regime of zero interest rates, quantitative easing, and the targeting of a real variable (the unemployment rate) using nominal variables. The latter is a reversion to stone-age Keynesianism. Indeed, current Fed policy has enabled a fiscal policy of high deficits and rapidly mounting national debt, anyway.

The Fed's independence of "politics," has begun to be challenged even by economists and financial pundits.

An Austrian View of Money, Taxation, and Spending

Let us grant for the sake of argument that congressional control of monetary policy alters the mix of financing government spending toward less taxation and more deficits financed by money creation. From the point of view of Austrian public finance theory, the *method* of governmental "revenue extraction" does not matter nearly as much as the *total amount* extracted. For all government spending drains resources from productive uses in the private economy and squanders them on the wasteful spending of politicians and bureaucrats on their favored projects and constituencies. Government spending is either consumption spending that directly satisfies the preferences of members of the political establishment or it is investment in waste assets because it is not based on the profit and

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This article is adapted from an paper appearing in the Winter 2015 issue of *The Journal of Private Enterprise*.

JOSEPH SALERNO, CONTINUED

capital-value calculations that guide the decisions of private entrepreneurs and capitalists. It is in effect a redistribution of income and resources from the productive to the unproductive, from the "taxpayers" to the "tax-consumers."

The total amount of government spending is therefore what Murray Rothbard called "government depredation on the private product." For Austrian economists, then, the method of financing government depredation — whether it be taxation, borrowing from the public, or money creation — is of secondary importance. Thus, *at a given level of government spending*, siphoning off resources from the private economy via deficits financed by money creation is no worse than extracting them through taxation. Indeed inflationary finance may even be preferable to taxation because the threat of physical coercion implicit in taxation has a detrimental effect on the direct utility of private individuals that goes beyond the expropriation of their income.

Needless to say, from the point of view of consumer welfare and economic efficiency, a smaller government budget financed by money creation is preferable to a larger budget that is in balance.

Obviously, legislative control of the fiat money supply is far from the ideal monetary system, and my sole purpose here is to suggest a politically feasible solution to the urgent problem of arbitrary power exercised by a clique of Federal bureaucrats.

The desideratum of the Austrian political economist with classical-liberal or libertarian leanings involves the complete separation of government and money through the establishment of a commodity money like gold (or silver), the supply of which is determined exclusively by market forces. Nonetheless, there is great merit in replacing the opaque and pseudo-scientific control of "the money supply process" by entrenched Fed employees and officials with overtly political control of money by elected officials and partisan administration appointees. There are a number of benefits of stripping the Fed of its quasi-independent status and transforming it into a handmaiden of the Treasury, as the American Monetary Institute (AMI) and early Friedmanite reform programs call for.

How It Would Work

First, money would be created in a transparent manner that is understandable to the public at large. The Treasury would simply send an administrative order to the Fed to credit its checking account with the sum of money needed to pay the government's bills that are not covered by tax revenues. Now, formally, this order may be called a "Treasury bond," but it would not be a bond in the economic sense because it would not be exchanged in financial markets. Nor would the "interest" that the Treasury may pay on these pseudo-bonds really be interest because it would not be determined by supply and demand on financial markets. Rather it would be a payment to reimburse the administrative costs of the Fed and its amount would be completely controlled by the Treasury. It thus becomes evident to the public that every increase in the money supply engineered by the Treasury benefits the *specific* individuals and firms receiving government checks. The new money is being created from nothing to purchase military aircraft from Boeing, to subsidize agribusiness giant Monsanto, to bail out General Motors, etc.

This contrasts with the arcane process by which money is now created, which involves the Treasury issuing debt that is purchased by private entities, mainly banks and other financial institutions, and then eventually repurchased by the Fed via open market operations. In this way the Fed circuitously "monetizes the debt" and expands the money supply while distorting interest rates in the bargain. Invisible to the layperson is the fact that twenty or so privileged Wall Street (and foreign) banks and financial institutions — so-called "primary dealers" — that sell bonds to the Fed profit immensely from the money creation process. Also benefitting from the newly created reserves are the commercial banks' business clients who borrow the money at reduced interest rates and spend it to appropriate extra resources before prices have begun to rise.

Furthermore, under this plan, the Fed would no longer function as a discretionary lender (bailer-outer) of last resort, a role that infects the entire financial system with pandemic moral hazard. No longer would the Fed be able to surreptitiously, arbitrarily, and without democratic oversight or accountability bail out all kinds of financial institutions in the United States as well as foreign countries. First of all there would be no need to bail out pure depository institutions because all such institutions would hold 100 percent reserves. But, second, even if purely financial (non-money-issuing) institutions were in danger of failing, the decisions to bail them out would be made by an openly partisan Treasury under the watchful eye of the congressional opposition and in full view of the public. With the Fed neutered and unable to leap to their rescue at the first sign of distress and with their appeals for bailouts subject to full scrutiny by a skeptical congress and public, financial institutions would run their affairs much more prudently.

events

February 27 — "Why Rothbard Matters" with Bob Murphy at ISFLC, Washington, DC

March 31 – April 2 — Austrian Economics Research Conference; Mises Institute

May 21 — The Mises Circle in Seattle, Washington

June 5 – 10 — Rothbard Graduate Seminar; Mises Institute

July 24 – 30 — Mises University; Mises Institute

October 1 — The Mises Circle in Boston, Massachusetts

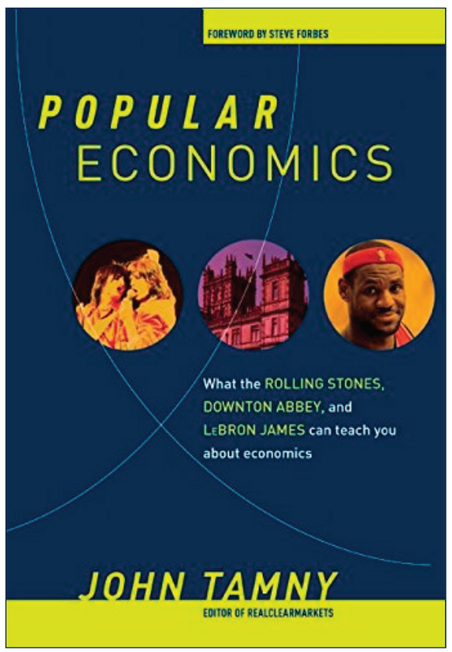
November 5 — The Mises Circle in Dallas/Ft. Worth, Texas

Student scholarships available for all events. See mises.org/events for details.

ECONOMICS: IT'S SIMPLER THAN YOU THINK

DAVID**GORDON** REVIEWS

Popular Economics: What The Rolling Stones, Downton Abbey, and LeBron James Can Teach You About Economics
John Tamny
Regnery, 2015
xxiii + 279 pages



In the view of John Tamny — an editor at *Forbes* and *RealClearMarkets* — economics as it is usually studied and taught in universities is unnecessarily complicated. The basic truths of economics are simple and require no difficult mathematics to understand. Readers will be reminded of Hazlitt's great *Economics in One Lesson*.

Entrepreneurs vs. Bureaucrats

The book is animated by a controlling vision. A successful economy depends on innovative entrepreneurs who are willing to take large risks in return for the chance at great profits. It is essential to prosperity not to hamper the efforts of these entrepreneurs through governmental efforts to tax and regulate the economy. Tamny illustrates his thesis with many stories about famous persons, as the subtitle of the book suggests.

The government, Tamny emphasizes, produces nothing on its own. It operates by taking resources away from the productive. To the objection that the government may itself use money it takes in taxes for purposes beneficial to the economy, Tamny answers that people successful in business are highly likely to be better judges of what is beneficial than bureaucrats in the government. If the bureaucrats were better able to discern profit-making opportunities, they themselves would be entrepreneurs. High level bureaucrats may earn substantial salaries, but the wealth of those in business is far greater. "If you're so smart, why are you a bureaucrat?"

To this, one can imagine someone objecting: Even if it is right that successful entrepreneurs will raise economic productivity, does this not bring with it a great danger? What about inequality? What if the successful entrepreneurs do so well that they accumulate vastly more wealth than others? Thomas Piketty has notoriously made much of this point; but Tamny has an effective and simple answer to it. Great accumulations of wealth are desirable: the rich will invest their money, and everyone will benefit. "When the rich 'hoard' their wealth, it is loaned to those who need money for cars, clothes, and college tuition, not to mention the next generation of Bill Gateses, full of ideas but in need of the capital that will abound if some of society's richest keep their wealth intact so it can pass to future generations."

If high investment is the key to prosperity, the capital gains tax is especially to be deplored. "Investors who might risk their capital in the private sector know they might lose it all, and they face a 20 percent tax on whatever return they do get on their investment. Those same investors have the option of buying government bonds, and, though the returns are small, they're reliable and, in the case of municipal bonds, tax-free. ... Our tax code ... puts entrepreneurs at an enormous disadvantage when they compete with the government for investors."

Taxation is of course not the only way the government hampers the free market. Attempts by government to regulate the economy face exactly the problem that Tamny finds with taxation. Antitrust laws, for example, purport to prevent companies from gaining monopoly control of important commodities; but are not those on the scene better qualified than government "experts" to assess whether market conditions make mergers desirable? Once more, it is entrepreneurs, not government officials, who are skilled at anticipating future demand. "Mergers are ultimately about survival. Companies must adjust to an uncertain future business climate, and restraining the ability of larger businesses to act in the best interests of shareholders is counter-productive. Antitrust regulation does not foster competition so much as it reduces successful companies to sitting ducks."

"Capitalist Societies Can Rebound from Anything"

We have so far omitted a key part of Tamny's argument. Skilled entrepreneurs succeed, but many in business fail. The market operates by sorting out of the successful from the failures by the test of profitability. Given this fact, it is as essential that the failures be allowed to fail as it is that those who succeed be allowed to keep their profits. Attempts to prop up failures disable the market.

This vital point can be used to answer a common objection to free trade. Many people object to free trade because, in some cases, foreign competition drives domestic companies out of business, causing unemployment. To the response that expanded trade creates jobs elsewhere in the economy, the reply often given is, what about the workers who *do* lose their jobs? They are often unable to secure new jobs as good as those they had previously. The fact that others are better off is small solace to them.

Tamny's account of the way the free market works makes it impossible to accept the objection just given. "In a free economy, capital migrates to talented entrepreneurs eager to pursue profitable opportunities.

It is entrepreneurs, not government officials, who are skilled at anticipating future demand.

Innovations like the automobile, computer, and online retail services destroy jobs, but the process leads to better, higher-paying jobs ... to create jobs in abundance, we must allow the free marketplace to regularly annihilate them." Tamny acknowledges that "the progress of job creation through job destruction does not make losing your job less agonizing. ... Yet getting laid off is not cause for despair. Good often comes from losing your job." Workers, like capitalists, need to be alert to new opportunities.

In a manner showing great insight, Tamny applies the point about falling businesses to the financial crisis of 2008. According to Ben Bernanke, Timothy Geithner, and many others, only the massive bailouts of financial institutions in response to the collapse of the housing market saved the economy from disaster. Tamny reverses this contention. It was essential to the proper working of the market to allow the businesses that had acted recklessly to fail. Had this been done, the economy could have quickly readjusted. "Capitalist societies can rebound from anything. In particular, they can bounce back from

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DAVID GORDON, CONTINUED

bank failures that do not exterminate human capital or destroy their infrastructure. An interfering government is the only barrier to any society's revival, and that is why the global economy cratered amid all the government intervention in 2008."

Gold, Money, and the State

So far there has been little reason to dissent from the author's principal arguments. In monetary theory though, he makes what seems to me an incorrect claim; but fortunately, his main policy prescription can be restated in a better way. Tamny rightly calls for sound money. He rejects as misguided inflationary efforts to reduce our "unfavorable" balance of trade. As he points out, a trade deficit is not at all to be feared. "All trade balances. Trade 'deficits' with producers from near and far away are the rewards for everyone's productivity."

So far, so good; but he errs when he compares the dollar to a measuring rod that must not change. "Just as the foot is never long or short, money should be neither strong nor weak. The foot is a standardized tool to measure actual things, and money should have the same constancy." What is his argument for this view? As he points out, people want money, not for its own sake, but in order to purchase goods and services. (We set aside a few exceptions.) He thinks that from this fact, if the government follows the proper policy, the value of money can be kept constant. Relative prices of goods and services will change, to reflect changes in their supply and demand. Money can then serve as a measuring rod, to enable people to assess these changes in relative prices. It does not follow, though, that because money is demanded as a means to get other things, there is no independent demand for money at all. In the free market, money is a commodity whose price can change.

Even if Tamny is wrong on this point, though, his main message can be salvaged. It is entirely desirable that the monetary commodity be one unlikely to be subject to substantial fluctuations in price. The gold standard abundantly meets this requirement, and this gives Tamny all that he can reasonably want. To speak of measuring rods merely darkens counsel, as Mises long ago pointed out. "Although it is usual to speak of money as a measure of value and prices, the notion is entirely fallacious. So long as the subjective theory of value is accepted, this question of measurement cannot arise." (Mises, *Theory of Money and Credit,* chapter 2.)

The book's many insights far exceed in importance this disagreement about money as a measure of value. *Popular Economics* is an outstanding book that, if read widely, will greatly improve public understanding of basic economic truths.

David Gordon is Senior Fellow at the Mises Institute, and editor of *The Mises Review.*

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IN DEFENSE OF DEFLATION

A CONVERSATION WITH **PHILIPP BAGUS**

Philipp Bagus is a former Fellow and an Associated Scholar of the Mises Institute, and associate professor at Universidad Rey Juan Carlos. Professor Bagus recently spoke with us about his new book *In Defense of Deflation,* released last year by Springer.

Mises Institute: What prompted you to write this book?

Philipp Bagus: One reason is that there was simply no complete treatment of deflation. The other reason is that the fear of deflation has brought disastrous consequences for our economies. This is so because the alleged threat of deflation is used to justify the production of new money. Central bankers argue today that if they do not engage in quantitative easing and other unconventional policies, our economies will slide into a recession and a price deflation. And, implicitly, price deflation is portrayed as something horrible. It is so widely regarded as horrible, in fact, that anti-deflationists do not even think it necessary to prove their claims and analyze the phenomenon systematically. Therefore, I thought it useful to analyze deflation.

MI: You note in your book that deflation is a neglected topic in economics textbooks. Why do you think this is, and what is the most misunderstood aspect of deflation?

PB: One reason is that we have lived after World War II in a world of continuous price inflation. Therefore, textbooks dedicate much time to price inflation but not to price deflation. Deflation simply hasn't been a common experience in recent decades. And again, there remains the prevailing idea that deflation is self-evidently bad.

PHILIPP BAGUS, CONTINUED

The most misunderstood aspect of deflation is probably that price deflation is not a general economic problem. Falling prices merely lead to redistribution. Sellers lose and buyers win.

But, we are all buyers (of goods and services) and sellers (of goods and labor services). Companies also buy factors of production and sell products. So price deflation per se is not harmful to all, but only to those whose selling prices fall faster than their buying prices. Yet, the selling prices of some are the buying prices of the other side of the exchange. So when there are people who lose, then there are necessarily people who win. The selling prices fall slower than the buying prices.

It is also true that debtors lose in a price deflation. But the purchasing power that debtors lose, creditors win. And if a company goes bankrupt due to its nominal fixed debt, the creditor takes over the assets and may continue production, if the business is in principle viable and only went down due to its debt. This change in ownership does not disturb the productive potential of the economy (i.e., factories and machines do not disappear). Thus, price deflation is no general economic problem, but it leads to a redistribution.

Price deflation that is caused by the government may, of course, be considered to be harmful on moral grounds. This is not the case for price deflation that occurs on a free market or is a market reaction to government intervention.

MI: What are the policy implications of this? How does this mixture of winners and losers cause so much fear of deflation among policymakers?

PB: The policy implication is that one should not listen to people who argue that you need inflationary monetary policy to prevent price deflation at all costs because deflation is the end of the world.

Inflation will itself cause a redistribution in favor of the first receivers of the new money, it will distort relative prices, benefit debtors, prop up malinvestments, and potentially finance even new distortions and bubbles. It is completely understandable that those who benefit from inflation are spreading myths about the evils of deflation.

Who benefits from continued inflation? Well, the political and business elites. The biggest debtor in our economies is the state. Also many business elites are highly indebted. They would lose out in a scenario with price deflation. Therefore, they portray it as a general problem, even though credits would benefit from deflation. And as a policy remedy, the anti-deflationists argue in favor of the production of new money of which they, the government, the financial industry, and other business elites, will be the first recipients. In other words, these elites benefit from the creation of new money — which they can spend before prices adjust upward — at the expense of those who only receive the money after price inflation has already occurred.

MI: So why do so many economists blame deflation for the depressions of the past?

PB: Many economists are empiricists. So they look at history and come up with conclusions. They see that during the Great Depression a very strong economic downturn was accompanied by deflation. Then they think that it was the deflation that caused the downturn or made it stronger.

Keynesians also think that a recession occurs due to a collapse in aggregate demand. They do not understand

that people produce in order to demand. So there can be no general overproduction. If not everything produced is demanded, the structure of supply must be adapted to the demand. And here price deflation or monetary deflation may speed up the readjustment of the structure of production by liquidating malinvestment and shifting resources faster into projects that produce goods and services which consumers demand more urgently.

MI: Can we point to deflationary periods where there was an increase in the standard of living?

PB: Of course. During the nineteenth century in many countries we observed falling prices caused by strong economic growth. In the book, I analyze in detail the United States from 1865 to 1896. During this period the US experienced thirty years of falling prices and a strong increase in the standard of living at the same time. In fact, the natural result of economic growth is that prices tend to fall and the population enjoys the increase in production in form of lower prices. Something we observe today in the technology sector.

MI: In your book, you quote influential economist Brad DeLong who observed that declines in prices once seemed to be extremely unlikely. But now it seems more likely. Why do you think that is? In other words, why are inflation numbers nowadays coming in so far below those 2 percent targets set by central banks?

PB: There has been a deleveraging by the financial sector. The credit contraction exerts a downward pressure on prices. But there is also economic growth, not only in developing countries but also in Western economies where entrepreneurs after the crisis adapted the structure of production.

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The IMF's Global Tug-of-War

BY CARMEN ELENA DOROBĂȚ

It seems like every other news story about the International Monetary Fund (IMF) reflects (at least in passing) on the Fund's uneven treatment of developed and developing countries. Established at the Bretton Woods conference to oversee the system of fixed exchange rates prevailing in 1944, the Fund's mission has gradually expanded to promoting economic growth, macroeconomic stability, and poverty reduction.

Yet no one seems convinced anymore that the Fund can actually accomplish these goals. To the contrary, many now argue the IMF is a highly politicized organization, biased in its choice of whom to help, how, and how much. For instance, critics argue that Christine Lagarde (current managing director of the IMF) is keen on denying African countries agricultural subsidies as part of the IMF loans conditionality, even though she supports the same measures — labelled "economic incentives" — when it comes to the EU Common Agricultural Policy and the French farmers.

While critics often perpetuate many economic fallacies themselves — such as "beneficial subsidies," or the better-known "exploitation" of developing countries by their developed counterparts — they are not entirely mistaken in their misgivings about the Fund. There is something inherent in what the IMF does that perpetuates conflict among and within national economies. This has to do with the monetary-policy principles on which the Fund was established.

How the IMF Spreads the "Wealth"

The IMF's funds for loans are drawn from the expanded money supplies of its member countries on the basis of a contribution quota, and then redistributed to countries in need of financial or foreign exchange stabilization. The list of borrowers ranges from France in 1947 and Argentina (just before its 2001 crisis) to Ireland, Portugal, Ukraine, Colombia, Greece, and many others.

These loans promote an artificial and temporary type of global economic growth, because they do not have a neutral impact on the world economy. IMF loans endow some countries with additional purchasing power, thus allowing them to increase their command of resources and their wealth to the detriment of other countries. The latter's resources and overall wealth are diminished by the depreciation of the monetary unit purported by every disbursement of the new money.

This global, inter-country redistribution of wealth is central to the conflicting relationships which arise around the allocation of IMF packages. Mises explained this to his students at FEE in the 1960s when he noted that the central problem is over who gets the money: "Everybody, every country, would say the same thing: 'The quantity we got is too small for us.' The rich countries will say, 'As the per head quota of money in our country is greater than it is in the poor countries, we must get a greater part.' The poor country will say, "No, on the contrary. Because they have already a greater part of money per head quota than we have, we must get the additional quantity of money."

But, Mises observed, it's impossible to distribute the money in a neutral way: "one can never increase the quantity … in such a way that it does not further the economic conditions of one group at the expense of other groups. This is, for instance, something that wasn't realized in this great error — I don't find a nice word to describe it — in starting the International Monetary Fund."

The IMF, Inequality, and Central Banks

These conflicts are underlined by an even less acknowledged conflict at the national level — also predicated on the redistribution of wealth — which arises from the inflationary policies of national central banks. National central banks often cooperate with each other to, as Jörg Guido Hülsmann summarized, "to *coordinate* central-bank policies, i.e. … to increase their note issues in concert, thus avoiding the embarrassment of the falling exchange rates that inevitably result from unilateral inflation."

However, when this coordination fails, IMF loans can be used to buy one's currency off foreign exchange markets and temporarily halt its collapse. Here too, instead of macroeconomic stability, what IMF loans really accomplish is maintaining the inflationary monetary policies which have brought countries to this predicament in the first place. The primary social consequences of inflationary policies are the redistribution of wealth from the last receivers of the new money toward the first receivers. Thus, the perpetuation of this institutional framework is a fertile ground for growing economic inequality, a hot issue nowadays, often overestimated, but always blamed on the free market.

Carmen Elena Dorobăț is a former Mises Fellow and a lecturer in international business at Coventry University.

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JOSEF ŠÍMA

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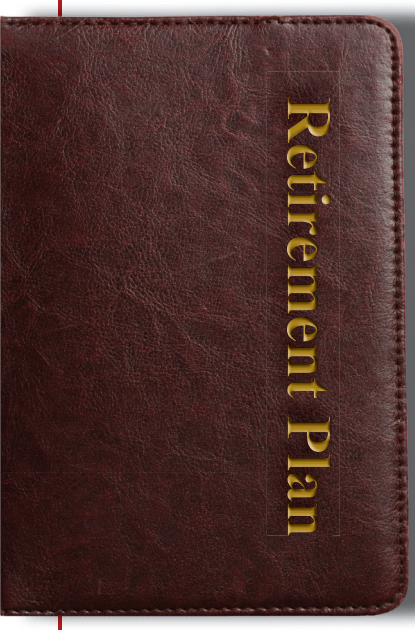

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