

# The Austrian

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## The Fed's Great Unwind

*Will It Sink Us?*

Thorsten Polleit

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# From the publisher

## Jeff Deist

**D**o you feel richer these days? Maybe you should. After all, equity markets seem to reach new all-time highs every week. As I write this (mid-October), both the Dow Jones and the Nasdaq are red hot and rising. The Department of Labor tells us unemployment claims are at a 43-year low (though we all know how dishonest that stat is). And although auto sales are down a bit compared to last year, the taste for luxury remains strong even among middle-class US consumers: the “luxury pickup” market is booming, led by a fully loaded 2018 Ford F-450 pickup with a sticker price of \$90,000. Meanwhile the *Wall Street Journal* is happy to report the latest house selling for \$100 million in Beverly Hills or Kensington Gardens or Dubai.

If this feels like déjà vu, consider that monetary policy has been on steroids since the Crash of 2008. Instead of organic growth in new markets, productivity gains, and real corporate earnings, the worldwide economy has become a financialized, debt-laden scheme designed to prop up stock prices. So the party goes on, buoyed by our belief that we are at least rich on paper.

Our cover story by Dr. Thorsten Polleit is about the coming hangover when the party stops. The Federal Reserve and other central banks, along with their client governments, lost their collective minds during the Crash of 2008. They decided the cure for too much debt and credit and insolvency was more debt and credit and insolvency.

Scrambling for answers during what David Stockman calls the “Blackberry Panic,” central bankers at the Fed and around the world created trillions of dollars in new bank reserves to provide liquidity for banks and insurance companies. It was a bailout, plain and simple, posing as economic salvation for Main Street. And the succeeding rounds of monetary expansion — quantitative easing — led us into a new era of “extraordinary” monetary policy. No society in human history ever simply created money, or at least base money, on this scale.

Now the unprecedented experiment is coming to an end. As Dr. Polleit explains, the Fed’s attempt to unwind

its balance sheet is like taking a narcotic from an addict. The Fed is afraid of going cold turkey, but its gradualist approach only threatens to turn a sharp painful correction into a long one.

The root of the problem lies in the distortion caused by manipulating the most important prices in any economy: interest rates. But it’s not only equity markets that cheer for low or even negative rates. The political class too cannot resist the allure of ersatz economic growth propped up by cheap and easy credit, not to mention keeping the federal government’s own debt service manageable. It is the easiest way to win votes and push problems off onto the future.

That is why there is more total debt today owed by governments, businesses, and individuals than in 2009,


“For the naïve mind there is something miraculous in the issuance of fiat money.”

Ludwig von Mises  
*The Theory of Money and Credit*

when the world supposedly began deleveraging in earnest: a staggering \$152 trillion.

The credulous financial press doesn’t get it, praising Janet Yellen’s “steady hand.” Academic economists don’t get it either. The Nobel committee recently awarded its pseudo-prize in economics to Richard Thaler, a “behavioral economist” who fails to distinguish action from motivation 80 years after Mises explained praxeology.

The good news is that more people around the world now understand that central bankers are flying blind. The next stock market crash will once again create tremendous thirst for Austrian insights on banking, business cycles, and money. And the Mises Institute will be at the forefront, just as we were in 2008, of explaining how the bubble grew, why the crash happened, and how to correct the course.

If you attended our 35th Anniversary gala in New York City, you witnessed the energy and enthusiasm among young people for our message. If not, enjoy the beautiful photos on pages 10 and 11. We look forward to connecting with all of you in 2018. 

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Jeff Deist is president of the Mises Institute.



# The Fed's Great Unwind

## *Will It Sink Us?*

Thorsten Polleit



In the eyes of many people, the Federal Reserve (Fed) is an indispensable institution. We are told it supports growth and employment, fends off the negative shocks, and fights inflation. Nothing could be farther from the truth. The Fed's *fiat money regime* is economically and socially highly destructive — causing far-reaching societal and political consequences that extend beyond what most people would imagine.

Fiat money is inflationary, it debases the purchasing power of money; it benefits a few at the expense of the many; it causes boom-and-bust cycles that hurt many people economically; it makes people run into too much debt, leading to over-indebtedness; it corrupts society's morals; it makes government grow at the expense of individual liberty;



it encourages the state's aggressiveness and fuels its war machine.

Tragically, however, people consider falsely the Fed as their “knight in shining armor” coming to their rescue in times of trouble rather than what the institution really is: the very source of economic and societal grievance. People do not blame the Fed for the trouble it causes, but instead welcome Fed action for overcoming the damage it has caused in the first place. That is why many people keep their fingers crossed that the Fed's latest “exit plan” will succeed.

## The Fed's Exit Plan

In the course of the financial and economic crisis of 2008–2009, the Fed lowered interest rates to basically zero. It also increased its balance sheet from \$879.4 billion at the end of 2007 to \$4.5 trillion in September 2017. It did this by purchasing US Treasuries and agency mortgage-backed securities (MBS) in the amount of \$2.4 trillion and \$1.7 trillion, respectively, thereby having injected additional ‘base money’ into the US banking system.

Recently, the Fed has changed course. It has raised its target interest rate from near-zero to a still-tiny rate slightly above 1 percent. What is more, the Fed has decided to start shrinking its balance sheet beginning in October 2017 by gradually reducing the reinvestment of principal payments from its security holdings. Specifically, it will reinvest each month's principal payments only to the extent that such payments exceed gradually rising caps.

The cap will be set at \$10 billion per month in October 2017 and stepped up each quarter, reaching a maximum of \$50 billion per month a year later. This will bring the Fed's balance sheet of US dollars down by an estimated \$1.7 trillion to \$2.8 trillion at the end of 2020 — which would still be \$1.9 trillion above its pre-crisis level seen at the end of 2007.

The Fed's exit plan has spooked some investors.

It is feared that the Fed's draining of liquidity from the banking sector could result in an overly restrictive effect on credit markets. This, in turn, could push borrowing costs upward, sending the economy — and financial markets in particular — down, even potentially

paving the way toward a new full-blown crisis. So what is to be made of the Fed's plan to unwind its balance sheet in the years to come?

## Reducing the Money Supply Could Lead to a Bust

The Fed's envisaged reduction in reinvesting maturing bonds in its portfolio will affect the quantity of credit and money.

**People consider falsely the Fed as their “knight in shining armor” coming to their rescue in times of trouble rather than what the institution really is: the very source of economic and societal grievance.**

The Fed, however, is proceeding with extreme caution, afraid that any sizable change would cause the interbank interest rate to spike and bring down the entire economy and financial system.

In practice, the Fed will thus have to keep sitting on a significant part of its bond holdings and buy new bonds once they mature. A true and final exit from the Fed's active role in the credit market — and thus an end to long-term interest rate manipulation — is therefore nowhere in the near future.

Whether or not the Fed's plan will actually result in a contraction in the quantity of money will depend on two conditions: The banking sector's willingness and ability to expand its balance sheet and investor appetite for agency MBS (or other credit products).

CONTINUED ON NEXT PAGE



THORSTEN POLLEIT, CONTINUED

## The Safety Net

To make the unwinding of (part of) its securities holdings run smoothly, it should be clear that the Fed has to continue to cater to the needs of banks and fixed income investors. Perhaps most importantly, the Fed will have to hold up its ‘safety net’ — a tacit promise that operates already in the shadows: to stand ready at any time to prop up the economy and financial markets from collapsing.

This is, in fact, exactly what investors have learned from the last crisis: the Fed, in its determination to keep the fiat money regime going, has made all too clear that it is willing, and has the capacity, to take recourse to manipulative policies (in the form of suppressing interest rates) and raising inflation (that is expanding the quantity of money through credit expansion) to keep the economy afloat and prop up financial market prices.

If and when investors remain confident that the Fed’s safety net remains in place whatever comes, the (partial) winding down of the Fed’s bloated balance sheet is unlikely to cause disruptions in the smooth functioning of financial markets and the continuation of the monetary policy induced expansion of the economy. The truly critical factor in all this is, however, the level of market interest rates.

## The Great Distortion

For the latest economic recovery has been, first and foremost, fueled by artificially low interest rates. Exceptionally low borrowing costs have encouraged firms to invest more, private households to consume more, and the public sector to spend more — and so growth seems to have returned. If interest rates rise, however, the monetary policy induced economic upswing (“boom”) will come to a shrieking halt, most likely to fall back into recession (“bust”).

But not only is the continuation of the Fed’s low interest rate policy required to keep the current boom going. By no means less important is the corollary of the Fed’s

safety net. For it has created among investors the illusion of stability, encouraging investors to lose sight of unavoidable uncertainties and vagaries of real life; it has put to rest investor default concern, thereby artificially reducing credit premia and lowering borrowing costs.

It is fair to say that the economy and financial markets in particular have become, more than ever before, dependent on the Fed’s monetary machination: By having distorted interest rates and prices on the grandest scale, the Fed has actually established a “hall of mirrors”: a mirage of returning economic and financial prosperity. Nor will the Fed’s destructive policy be ended by the planned unwinding of its balance sheet.

Rather than look to the Fed for the solutions, a more practical and honest approach is to demystify the Fed’s damaging effect on the economy sooner rather than later.

The material liberation has liberated our spirits and has allowed us to live more fulfilling lives than before. So, I don’t want to hear the “money can’t give you happiness” thing. If *this* doesn’t make you happy — that people are free to do these things and pursue things they love — then there ain’t no satisfying you. ■■■

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Thorsten Polleit is chief economist of Degussa and macro-economic advisor to the P&R REAL VALUE fund. He is honorary professor at the University of Bayreuth and an Associated Scholar of the Mises Institute.





# New Membership Levels and Benefits

## Member - \$60 or more donation (or recurring pledge)

Receives *The Austrian* magazine  
Membership card  
10% discount in Mises Bookstore  
Invitation to Mises events, with discounted registration fees  
Special book signing invites  
Free access to Virtual Mises University

## Premium Membership – \$150 or more donation

Receives all the aforementioned benefits, plus:  
Free access to Virtual Mises University and exclusive online content  
15% discount in the Mises Bookstore

## Supporter – \$500 or more donation

Receives all the aforementioned benefits, plus:  
Monthly updates from Lew Rockwell  
Quarterly Impact Report  
20% discount in the Mises Bookstore

## Bronze Club – \$1,000 or more donation

Receives all the aforementioned benefits, plus:  
Invite to private VIP receptions  
Complimentary Mises publications

## Silver Club – \$5,000 or more donation

Receives all the aforementioned benefits, plus:  
Reserved VIP seating at all events  
Complimentary Mises publications

## Gold Club – \$10,000 or more donation

Receives all the aforementioned benefits plus:  
Your name is displayed at the Mises Institute  
Invitation to Chairman's Gold Club and Society  
Annual Meeting

Most importantly, Members receive the gratitude of our students.

**For more information about Mises Institute Memberships, phone or email  
James Dunavant, Director of Development (405.788.1532; jamesd@mises.org).**

## UPCOMING Events

December 9, 2017 — Mises Institute in Orlando, Florida

March 23–24, 2018 — Austrian Economics Research Conference; Mises Institute

June 10–15, 2018 — Rothbard Graduate Seminar; Mises Institute

July 22–28, 2018 — Mises University; Mises Institute

**Stay tuned for additional 2018 events in Texas, Seattle, and other cities.**

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Student scholarships available for all events. See [mises.org/events](http://mises.org/events) for details.



# Our Fellowship Program



**FOR YEARS**, Murray Rothbard longed for a program where he could work one-on-one with graduate students, young faculty members, and other scholars interested in carrying forward the scholarship of the Austrian school. Unfortunately Murray never lived to see his dream come to fruition. However, not long after he passed away, the Mises Institute was finally able to make this idea a reality, as over the past 20 years, Joseph Salerno, Guido Hülsmann, and Mark Thornton have built up what is now the Mises Institute's Fellows program.

It is an intensive program in which Fellows meet regularly with our faculty, develop their research ideas for publication — many of them top mainstream publications — and hone skills as teachers, writers, and professionals. Students take up residence at the Mises Institute where lifelong friendships are forged, and a commitment to top-quality scholarship is developed through rigorous debate guided by senior faculty members.

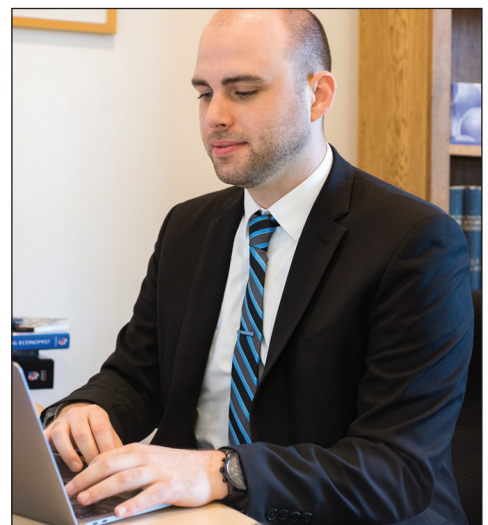




## . . . A Graduate School for Austrian Scholars

Our students and faculty know that the ideas of Austrian economics face hostility and rejection in many corners of both the academic and professional world. Austrian scholars face greater scrutiny than many others. So the Mises Institute strives to make sure that our Fellows leave the program as some of the best-trained scholars in their fields.

Faced so often with professional obstacles, the program can offer our Fellows an essential link with the global network of scholars and researchers forged by our faculty. As important as online and virtual education has become in recent years, there is still no substitute for personal relationship building among colleagues. The Fellows program fills this essential role in the working lives of many Austrian scholars today.





# Our 35th ANNIVERSARY

## GALA IN NEW YORK CITY

Hundreds gathered in New York City in early October this year to honor the life and works of Murray N. Rothbard and to celebrate the 35th anniversary of the Mises Institute. At a gala event October 6 and 7, attendees were treated to one of our best-ever group of speakers featuring Hans-Hermann Hoppe, Judge Andrew P. Napolitano, Ron Paul, Guido Hülsmann, Paul Gottfried, Tom Woods, Joe Salerno, David Gordon, Bob Murphy, Peter Klein, Walter Block, Doug French, Tom DiLorenzo, Mark Thornton, Jeff Herbener, Yuri Maltsev, Jeff Deist, and many others.

The event began with a hilarious bus tour of Murray's (and Mises's) favorite places in Manhattan, with insider info from guides Walter Block, David Gordon, Guido Hülsmann, Joe Salerno, and David Jarrett.

Our featured speakers were joined on the schedule by numerous panelists, including groups of former students of Murray Rothbard and current young professionals and scholars influenced by Rothbard and Mises, and their work.

Throughout the event, attendees were able to meet with our speakers for book signings and discussions.



**CLOCKWISE FROM ABOVE RIGHT:** Guido Hülsmann; Tom DiLorenzo; and tour guides Tom Woods and Walter Block.





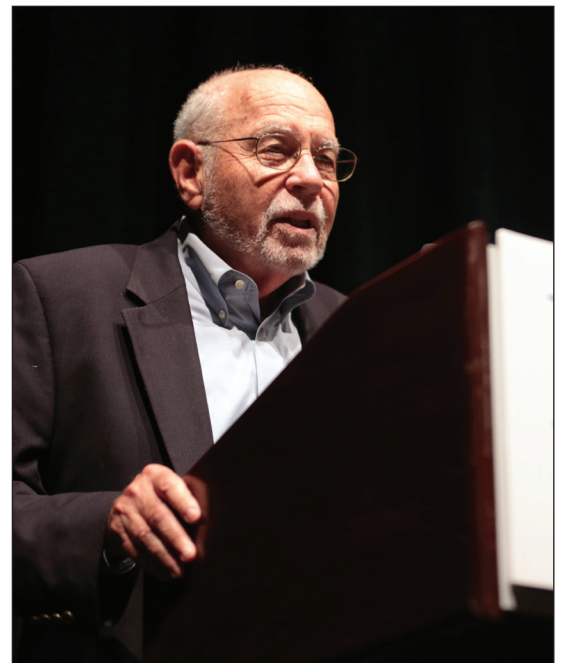


As with so many of our events, the audience was international. Attendees came from 33 US states, and 15 countries including Bahrain, Canada, Turkey, France, the Republic of Korea, the Netherlands, South Africa, Portugal, England, Italy, Ireland, Spain, Germany, Australia, and Hong Kong. Forty-nine high school and university students attended on scholarship.



**CLOCKWISE FROM LEFT:**

Dr. and Mrs. Ron Paul; Hans-Hermann Hoppe with Francisco García Paramés, who was the recipient of the Institute's 2017 Entrepreneurship Award; Hans Hoppe delivering the keynote address; Judge Andrew P. Napolitano, who was awarded the 2017 Rothbard Medal of Freedom; panel discussion "Murray's Future," with Bob Murphy, Ed Stringham, Ashton Faire, Patrick Newman, and Nicole Papakostas; and Paul Gottfried.





# THE EURO MIGHT DESTROY EUROPE

DAVID GORDON

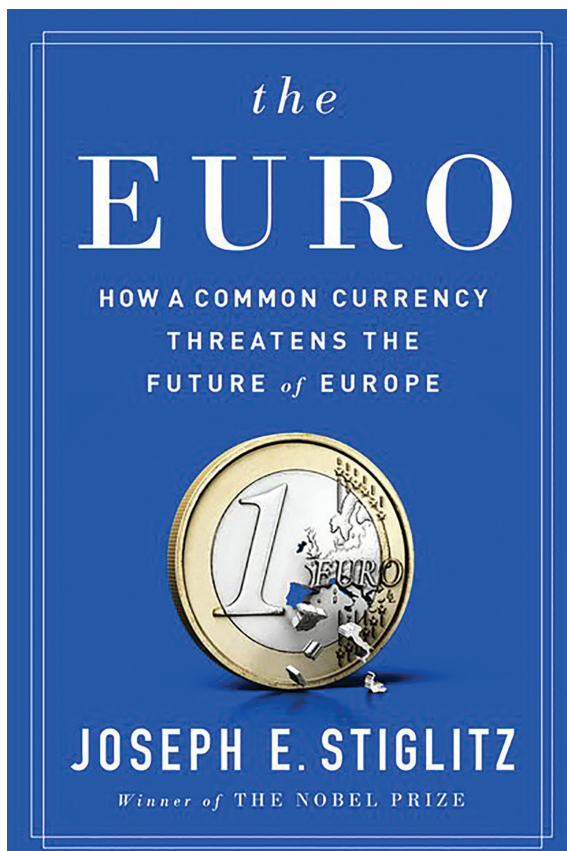
REVIEWS

The Euro: How a Common Currency Threatens  
the Future of Europe

Joseph E. Stiglitz

Norton, 2016

xxix + 416 pages



As Joseph Stiglitz sees matters, the euro suffers from a fatal flaw. The euro is the currency of 19 European countries; and common money blocks efforts of nations that, according to Stiglitz, need to devalue their currencies. More generally, attempts to restrict government control of the economy arouse the wrath of this implacable enemy of the market.

As he explains, “When two countries (or 19 of them) join together in a single-currency union, each cedes control over their interest rate. Because they are using the *same* currency, there is no exchange rate, no way that by adjusting their exchange rate they can make their goods cheaper and more attractive. Since adjustment in interest rates and exchange rates are among the most important ways that economies adjust to maintain full employment, the formation of the euro took away two of the most important instruments for insuring that.”

This limitation on government policy is more than a theoretical possibility. The Troika (European Commission, European Central Bank, and International Monetary Fund), influenced by nefarious German bankers, insists on “sound” money, much to the distress of Greece and other countries in need of economic stimulus. Making matters worse, the Troika demands that these countries raise taxes and slash government services, in order to reduce their huge debts. If these demands are refused, the Troika threatens to cut off further loans to the ailing governments.

If the euro is not to Stiglitz’s liking, the gold standard is even worse: “America’s depression at the end of the 19th century was

linked to the gold standard ... with no large discoveries of gold, its scarcity was leading to the fall of prices of ordinary goods in terms of gold — to what we today call deflation. ... And this was impoverishing America's farmers, who found it difficult to pay back their debts. ... So too the gold standard is widely blamed for its role in deepening and prolonging the Great Depression."

Stiglitz fails to note that many of the strongest defenders of the gold standard, e.g., Jacques Rueff, strongly condemned the gold exchange standard that prevailed in the 1920s. But never mind his historical mistake; let us concentrate on the most essential issue. Why does Stiglitz think that people cannot adjust to falling prices? Why must government control the money supply and, more generally, regulate the free market?

Here we arrive at the key to Stiglitz's thought. He is a Nobel laureate, according to many the most important economic theorist of his generation, and he claims to have *proved* that an unregulated free market must almost inevitably fail. "There is an abstract theory (called the Arrow-Debreu competitive equilibrium theory) that explains when such a system of unrestrained competitive markets might work and lead to overall efficiency, it requires markets and information that are far more perfect than that which exists anywhere on this earth. ... The circumstances that they [Arrow and Debreu] identified where markets did not lead to efficiency were called *market failures*. Subsequently, Greenwald and Stiglitz showed that whenever information was imperfect and markets incomplete — essentially always — markets were not efficient."

Stiglitz's criticism of the market rests on a false assumption. General equilibrium theory describes an artificial situation irrelevant to the actual working of the market. (The conditions resemble what Austrian economists call the evenly rotating economy [ERE].) On the free market, the wish to earn a profit induces producers to meet consumers' demands. We grasp how this process works through simple commonsense reasoning. As Mises explains, "This state of equilibrium is a purely imaginary construction. In a changing world it can never be realized. It differs from today's state as well

as from any other realizable state of affairs ... it was a serious mistake to believe that the state of equilibrium could be computed, by means of mathematical operations, on the basis of the knowledge of conditions in a nonequilibrium state. It was no less erroneous to believe that such a knowledge of the conditions under a hypothetical state of equilibrium could be of any use for acting man in his search for the best possible solution of the problems with which he is faced in his daily choices and activities" (Mises, *Human Action*).

## Why does Stiglitz think that people cannot adjust to falling prices? Why must government control the money supply and, more generally, regulate the free market?

Stiglitz would no doubt respond with derision. For him, mathematical models trump commonsense reasoning. As he remarks elsewhere, "The standard theorems that underlie the presumption that markets are efficient are no longer valid once we take into account the fact that information is costly and imperfect. To some, this has suggested a switch to the Austrian approach, most forcefully developed during the 1940s and later by Friedrich Hayek and his followers. They have not attempted to 'defend' markets by the use of theorems. Instead, they see markets as institutions that have evolved to solve information problems. According to Hayek, neoclassical economics got itself into trouble by assuming perfect information to begin with. A much better approach, wrote Hayek, is to assume the world we have, one in which everyone has only a little information. ... The new information economics substantiates Hayek's contention that central planning faces problems because it requires an impossible agglomeration of information. It agrees with Hayek that the virtue of markets is that they make use of the dispersed information held by different participants in the market. But information

CONTINUED ON NEXT PAGE



DAVID GORDON, CONTINUED economics does not agree with Hayek's assertion that markets act efficiently. The fact that markets with imperfect information do not work perfectly provides a rationale for potential government actions" (econlib.org/library/Enc/Information.html). Stiglitz "gives it away" in his last two sentences. The free market is deemed faulty because it falls short of the artificial standard of general equilibrium "efficiency." Where the free market is concerned, Stiglitz is a hanging judge.



Stiglitz has another argument to deploy against the free market, one that does not rely on the standard of competitive equilibrium. Keynes has shown that the free market needs to be propped up through government spending in order to maintain full employment. "An economy facing an economic slump has three primary mechanisms to restore full employment; lower interest rates, to stimulate consumption and investment; lower exchange rates, to stimulate exports; or use fiscal policy — increasing spending or decreasing taxes. ... I have just described the standard Keynesian theory on economic downturns." It is significant that here Stiglitz does not require a mathematical model that proves Keynesian stimulus policies *must* work. What happens, for example, if people fail to spend the money they receive to stimulate consumption — in the manner Keynesian theory assumes?

But why might fiscal stimulus not work? Here Benjamin Anderson and Robert Higgs, among others, have a convincing response. Uncertainty about what the government might do leads investors to lack confidence. If

so, Keynesian stimulus will fail. What is needed instead is a "business-friendly" policy from the government. Stiglitz's objection to this line of reasoning should by now be obvious. No mathematical model supports it: "There is a persistent view that confidence can be restored if governments cut deficits (spending), and with the restoration of confidence, investment and the economy will grow. No standard econometric model confirmed these beliefs." Stiglitz does not point out that there is substantial historical evidence, e.g., in a classic paper by Robert Higgs that uncertainty about government policy does indeed inhibit investment.

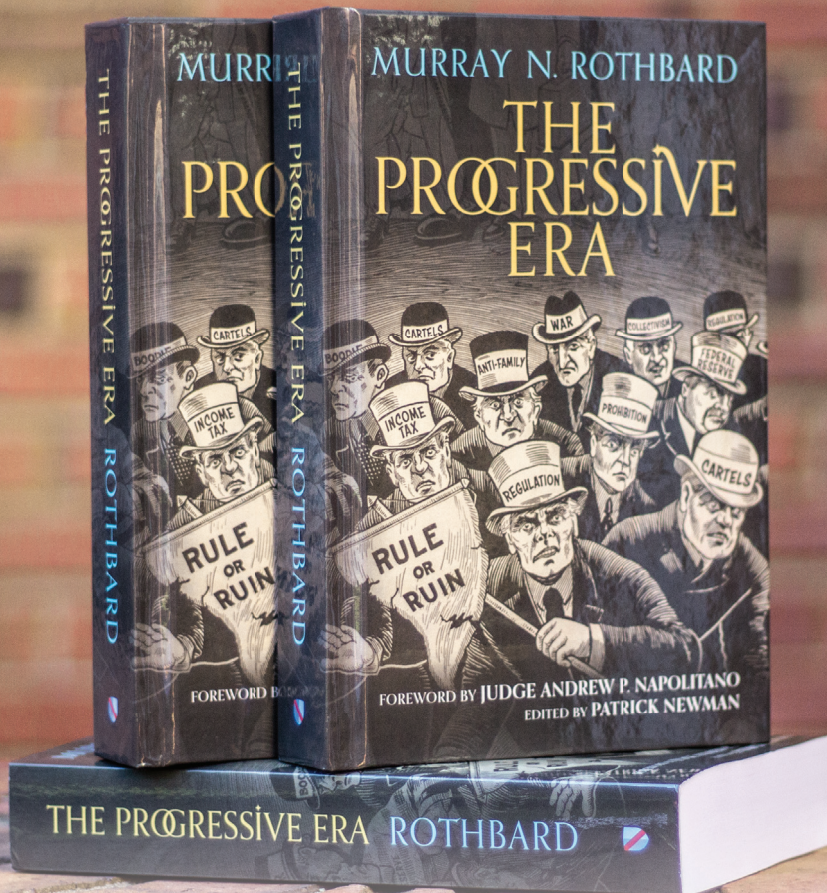
For Stiglitz, the principal enemies are the "market fundamentalists," but he has odd views about what support for the free market entails. "Faith in markets by neoliberals not only meant that monetary policy was less needed to keep the economy at full employment; it also meant that financial regulations were less needed to prevent 'excesses.' To conservatives, the ideal was 'free banking,' the absence of all regulations." But the free market ideal, as described by Mises and Rothbard, is very far from a system of unlimited private creation of fiat money. If the "excesses" Stiglitz mentions refer to speculative loans made possible by fractional reserve banking, the expansionist policies he supports lead to much greater instability than "market fundamentalism" tolerates. One wonders, further, why the Troika's demands that governments raise taxes to pay off large debts incurred by these governments are regarded as expressions of "market fundamentalism." It would seem more natural to regard these demands as one government program designed to remedy the defects of another.

Stiglitz does not consider Mises and Rothbard worthy of discussion. "Today, except among a lunatic fringe, the question is not whether there should be government intervention but how and where the government should act, *taking account of market imperfections*." He almost without exception proposes interfering with the free market, without demonstrating that the free market does not work. He agrees with the Queen in *Alice's Adventures in Wonderland*. "Sentence first — verdict afterwards." ■■■

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





# AN "ENTIRELY ORIGINAL" NEW BOOK FROM MURRAY ROTHBARD

Murray Rothbard's new book, *The Progressive Era*, was unveiled at our recent New York City gala. It is no mere appendix or addendum to previous works, but rather a fully developed original work in its own right, running well over 500 pages, and consisting almost entirely of new unpublished material. Only two essays in the book have been published by the Mises Institute in the past.

After the book's release, historian Paul Gottfried remarked that the book "testifies to the indefatigability of [Rothbard] as a research scholar ... the resulting synthetic study is entirely original."

As a topic for economists and historians, the Progressive era continues to be an essential topic for anyone seeking to understand our current ideologies, policies, and view of history. Rothbard always understood this well, which is partly why he spent so much time developing a much needed antidote to the current popular narrative on the Progressive era. Gottfried concludes: "One might welcome Murray's masterpiece on many grounds. One of them for me is that it affords a corrective to the dreary lectures I once attended as a college student on the merits of the Progressive era. One truth that came out of this experience was recognition that the Progressive era was a prelude to our present regime. *The Progressive Era* makes that abundantly clear."

The handsome new volume was made possible by many donors who gave specifically to make the book a reality.

Nor would the book ever have been possible without the efforts of Patrick Newman, a former Mises Fellow who spent many long hours at the Institute working with our staff to go through Rothbard's personal papers, editing and compiling the original documents. In other words, the project brought together resources the Mises Institute has sought to develop over 35 years: our collection of rare archival materials combined with new scholarship from our Fellows and students. ■■■



PATRICK NEWMAN



# THE FED'S CONFIDENCE GAME

## A CONVERSATION WITH **MARK THORNTON**



Does the Fed have a plan, or is it just hoping to weather the next crisis? Senior Fellow Mark Thornton talks about the Fed and the consequences of almost a decade of quantitative easing.

**THE AUSTRIAN:** As Austrians, we're often noting that we seek to explain and describe economic cycles, and not necessarily predict what's going to happen next week. So, how would you describe and explain the state of the economy right now?

**MARK THORNTON:** That is right. Austrian economics enlightens you about what will happen but not when and how much. Right now all the headline numbers are very good. The unemployment rate and the consumer price index (to the extent that you can believe them), along with the stock market all look remarkably well. However, we have had nearly nine years of historically low interest rates and that signals trouble ahead.

Not surprisingly, as a result of Fed policy, total household debt (mortgages, credit cards, auto and student loans) is fast approaching a record-breaking \$13 trillion. Investment in real estate and elsewhere is also at or close to bubble levels. There has been an enormous transfer of wealth from the middle class to the very wealthy as well. So, all the facts seem to line up with the Austrian business cycle theory.

**TA:** How do you think the economists at the Fed view things? Do they have an endgame in mind, or are they just trying to weather each crisis as it comes up?

**MT:** There are the public statements that Fed officials make to increase, or at least maintain consumer and investor confidence. They have a “confidence game” approach. Retired Fed officials have admitted that they cannot make public forecasts of recessions. According to the Fed the economy only gets better over time and we are never headed into a recession.

Of course they would like to normalize interest rates and their balance sheet, but they know that would create enormous problems. For example, the Fed’s monetary policy has created an enormous number of zombie companies, so if interest rates and expenses increase, then these companies would be forced to restructure and lay off workers. They continue to talk of “green shoots,” “normalizing interest rates,” and “selling off the balance sheet,” but they have not achieved any of this yet. Don’t hold your breath.

**TA:** At this point, we’ve literally been hearing from the Fed since 2009 that they’ll be normalizing monetary policy any day now. What do you think is the biggest reason that they’ve been so afraid to normalize? In other words, why hasn’t the current recovery been enough for them?



**MT:** When you look below the headline numbers, you see problems. I mentioned the zombie companies above. If interest rates go up they will start to show bigger losses. The auto industry has used low rates and subprime auto loans to sell cars. Now the manufacturers see growing inventories at all time high levels. Auto lenders have also hit an all time high in terms of the average length of loans, now close to six years. Auto dealers are bombarding the airwaves with deep discounts and zero financing. Throw in higher interest rates and the implications for manufacturers, employees, and consumers are all very negative. There are similar scenarios throughout the economy.

**According to the Fed the  
economy only gets better  
over time and we are never  
headed into a recession.**

Also, dependency on government and private welfare is at a very high level in America, so is economic fragility in terms of employment and savings. The Fed knows all this and is therefore very leery of igniting a recession.

**TA:** If you look for them, it’s always easy enough to find perma-bears saying somewhere that the economy is about to crash. We’ve been hearing that for years, but things continue along fairly evenly, even if weakly. Our sense, though, is that the Fed seems more concerned now than before, and that maybe they’re backed in a corner. Is this just our imagination?

**MT:** No it’s not your imagination. This cycle is different because of all the unorthodox and unprecedented monetary policy. I was bearish going into the financial crisis, but the economy got hammered with QE and then again with QE2. I thought a zero federal funds rate was as far as they would go and that they would normalize their policy as past Fed leadership had done. So that was a big surprise. I consider the Fed’s policy to be



MARK THORNTON, CONTINUED irresponsible because of what it has done to the American people and to the structure of the American economy. In addition, their interest rate policies have allowed Congress to double the national debt (in absolute terms and as a percentage of GDP) in a very short time. A doubling of interest rates would now cause interest payments by the federal government to roughly double from \$500 billion to \$1 trillion.

**TA:** 2017 is nearly over. Have there been any big surprises for you in terms of central banks this year, or have things proceeded much like you thought they would?

## The Fed's policy is grossly irresponsible and does tremendous damage to the structure of the American economy.

**MT:** Things have proceeded pretty much like I thought they would. Central banks do not like surprises, except the positive surprises of printing more money and reducing interest rates such as QE and QE2. They try to manage expectations. They claim one more rate hike in 2017 (probably in December) and three more in 2018. That is when things should start to get interesting whether they hike rates or not.

The story I am watching from my vantage point in Auburn, Alabama, is the expansion of capacity in terms of commercial and retail space and apartments. Some of it has already come online while more is under construction. All this new capacity means more debt, but will it also result in lower prices and profits? Auburn University has also undergone a mega building program in recent years. The City of Auburn is also building and upgrading infrastructure, schools, parking, and city hall. We have never seen anything like it.

Of course I am also watching the construction of the Jeddah Tower in Saudi Arabia. It is planned to be built



to a new record height and according to the Skyscraper Index could bring about a "Skyscraper Curse" or economic crisis in the near future.

**TA:** You stated above that the bubble economy has transferred wealth from the middle class to the wealthy. This reminds us that bubbles affect different groups differently. When the bubble finally bursts, which groups stand to lose out the most and why?

**MT:** The general pattern is that capitalists gain from cheap credit and labor is hurt by price inflation on the upside of the cycle. On the downside capitalists and the wealthy lose the most as asset values, like stock prices, collapse, while labor is relatively better off from lower price inflation or even deflation, e.g., lower home prices. This past cycle was different because of the bailout of the wealthy (which helped cause Donald Trump to be president). Those bailouts could happen again, but those bailouts distort the correction process which requires a complete adjustment of relative prices. ■■■



## In Memoriam

We mourn the passing, but celebrate the lives and achievements, of these great supporters of liberty and the Mises Institute. Their far-sighted concern for the future of freedom will always inspire us.

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