



# Cobden Partners

## Helping Nations Solve Banking Crises

The Coming Fiat Money Cataclysm – and After

By

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“An almost hysterical antagonism toward the gold standard is one issue which unites statist of all persuasions. They seem to sense ... that gold and economic freedom are inseparable.”

Alan Greenspan (1966)

“... the Age of Chartalist or State Money was reached when the State claimed the right to declare what thing should answer as money to the current money-of-account – *when it claimed the right not only to enforce the dictionary but also to write the dictionary*. Today all civilised money is, beyond the possibility of dispute, chartalist.”

John Maynard Keynes (1930)

A recurring theme in monetary history is the conflict of ‘trust’ and ‘authority’ – the conflict between those who advocate a spontaneous monetary order determined by free exchange under the rule of law, and those who wish to meddle with the monetary system for their own ends. This is perhaps most clearly seen in the early twentieth century controversy over the ‘state theory of money’ (or chartalism), which maintained that money is a creature of the state. The one side was represented by the defenders of the old monetary order – most notably, by the Austrian economists Ludwig von Mises and Friedrich Hayek, and by the German sociologist Georg Simmel; the other side was

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represented by German legal scholar Georg Friedrich Knapp and by the British economist John Maynard Keynes; they argued that on monetary matters the government should be free to do whatever it liked, free from any constraints of law or even conventional morality.

States have claimed the right to manipulate money for thousands of years. The results have been disastrous, and this is particularly so with the repeated experiments with inconvertible or fiat paper currencies such those of medieval China, John Law and the assignats in 18<sup>th</sup> century France, the continentals of the Revolutionary War, the greenbacks of the Civil War and, most recently, in modern Zimbabwe. All such systems were created by states to finance their expenditures – typically to finance wars – and led to major economic disruption and ultimate failure, and all ended either with the collapse of the currency or a return to commodity money. Again and again, fiat monetary systems have shown themselves to be unmanageable and, hence, unsustainable.

The same is happening with the current global fiat system that has prevailed since the collapse of the Bretton Woods system in the early 1970s. The underlying principle of this system is that central banks and governments could boost spending as they wished and ignore previous constraints against the over-issue of currency and deficit finance; implicitly, they could (and did) focus on the short-term and felt no compunctions whatever kicking the can down the road for other people to pick up. Since then loose monetary policies have led to the dollar losing over 83% of its purchasing power.<sup>2</sup> A combination of artificially low interest rates, loose money and numerous incentives to take excessive risks – all caused, directly or indirectly by state meddling – have led to an escalating systemic solvency crisis characterized by damaging asset price bubbles, unrepayable debt levels, an insolvent financial system, hopelessly insolvent governments and rising inflation. Yet, instead of addressing these problems by the painful liquidations and cutbacks that are needed, current policies are driven by an ever more desperate attempt to postpone the day of reckoning. Consequently, interest rates are pushed ever lower and central banks embark on further monetary expansion and debt monetization. However, such policies serve only to worsen these problems and, unless reversed, will destroy the currency and much of the economy with it. In short, the United States and its main European counterparts are heading for hyperinflationary depressions.<sup>3</sup>

### **The Impact of a Low Interest Rate Policy**

The impacts of state intervention in the monetary and financial system are subtle and profound, but also highly damaging and often unforeseen. A good place to start is Hayek's well-known analysis of the impact of a lower interest rate policy in *Prices and Production* in 1931. This focuses on the 'malinvestments' created by such policies – the unsustainable longer term investments that would not otherwise have taken place – that are eventually corrected by market forces that manifest themselves in a recession in

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<sup>2</sup> Using official BLS CPI data. By the same measure – which actually understates the problem - the dollar has lost 94.2% of its purchasing power since Roosevelt effectively ended the gold standard in 1934.

<sup>3</sup> For more on the coming fiat money collapse theme, see also, e.g., Shelton (1994), Lewis (2007), Schlichter (2011) and Williams (2011).

which earlier malinvestments are abandoned and the economy goes through the necessary but inevitable painful restructuring.

Some further insight into this process<sup>4</sup> is provided by a recent article by Art Carden on what can be learned about the Austrian theory of the business cycle from – of all things – reality TV. More specifically, he looked at celebrity chef Gordon Ramsay’s show *Kitchen Nightmares*. Every week, Ramsay helps resuscitate an ailing restaurant business that would otherwise fail. Carden’s point is that these are perfect examples of Hayekian malinvestments that should not have taken place and would not have, had credit been ‘correctly’ priced to begin with. This example illustrates important points such as the heterogeneity of capital – stoves, spatulas, chairs etc. are all part of the restaurant’s capital, but they are not substitutes for each other - and the point that if the restaurant eventually fails (as it would have, had a celebrity chef not arrived out of the blue on a white horse to rescue it) then a lot of this capital would be junked and the people working in it thrown out of work. The restaurant example also nicely illustrates the human cost, such as people investing in the wrong relationships and skills, and the impact of the resulting financial problems on family and health.

Low interest rate policies not only set off a malinvestment cycle, but also generate destabilizing asset price bubbles, a key feature of which is the way the policy rewards the bulls in the market – those who gamble on the boom continuing – at the expense of the sober-minded bears who kept focused on the fundamentals, instead of allowing the market to reward the latter for their prudence and punish the former for their recklessness. Such intervention destabilizes markets by encouraging herd behavior and discouraging the contrarianism on which market stability ultimately depends. A case in point is the Fed’s low interest rate policy in the late 1990s: this not only stoked up the tech boom, but was maintained for so long that it wiped out most of the bears, who were proven right but (thanks to the Fed) too late, and whose continued activities would have softened the subsequent crash. The same is happening now but in many more markets – financials, general stocks, Treasuries, junk bonds, commodities, etc. - and on a much grander scale. Such intervention embodies an arbitrariness that is wrong in principle and injects a huge amount of unnecessary uncertainty into the market.

Another unexpected and almost unnoticed effect of artificially low interest rates has been to replace labor with capital, leading to unemployment and attendant downward pressure on wage rates. This effect is very apparent if one contrasts recent low interest rates with the very high interest rates of the Volcker disinflation 30 years ago:

- Then, high real interest rates reduced the level of capital applied to the economy and made obsolete a high proportion of the existing capital stock. However, demand for labor remained high in the areas of the country that were not suffering from bankruptcy of their capital stock, in particular on the East and West coasts. Once the recession lifted, therefore, job creation was exceptionally buoyant.
- With recent low interest rates, on the other hand, it is labor that is substituted out: hence, job loss levels in the winter of 2008-09 were far above those of any recession since the early 1930s, and the level of long-term unemployment is far above that of the early 1980s, especially when one takes into account the regions

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<sup>4</sup> See also O’Driscoll (2011).

of ‘discouraged’ workers who have exhausted their benefits and dropped out of the unemployment statistics.

This effect is overlooked by Keynesians who maintain that lower interest rates lead to lower unemployment via greater spending, and is another example of the need to take account of relative prices and not just focus on aggregates alone.

A related effect is to encourage excessive outsourcing, as capital is excessively substituted for overseas labor and jobs and even innovation are moved offshore. Outsourcing a product or service to Asia not only makes it cheaper, but also increases the capabilities of the overseas workforce, raising its capability still further and making it competitive in more sophisticated products and services.<sup>5</sup> To some extent, outsourcing is a natural and beneficial aspect of globalization, but excessively low interest rates push this process too far. This happens in part by making capital too cheap, leading to too much overseas investment and excessive substitution of overseas for U.S. labor. This also happens by depressing yields, which leads yield-seeking investors into higher risk investments such as emerging markets: if Vietnam, for example, can then raise money almost as easily as Ohio, then capital will be diverted to lower cost Vietnam and manufacturing jobs that would otherwise have remained in the U.S. will migrate with it. This latter channel is a perfect example of the law of unintended consequences that illustrates how subtle the damaging consequences of low interest rate policies can be.

Artificially low interest rates also reduce the productive efficiency of the U.S. economic engine by adversely affecting productivity and the rate at which technological advance translates into living standards. This effect shows up clearly in the multifactor productivity data. The most recent data show that the quinquennium 2005-09 had a beggarly average multifactor annual productivity growth of only 0.2%, well below the post 1948 average of 1.17%.<sup>6</sup> Had multifactor productivity in 2005-09 risen at its long-term rate, we can reasonably speculate that output in 2009 would have been perhaps 5% higher. This ‘missing’ 5% of output indicates that the shortfalls in multifactor productivity associated with low interest rate policies should be taken seriously.<sup>7</sup>

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<sup>5</sup> In this respect David Ricardo’s Doctrine of Comparative Advantage, which in this context implies that outsourcing was unambiguously beneficial to both the rich outsourcer economy and the poor outsourcee economy, is seriously incomplete. Ricardo failed to take account of the improved capabilities in the outsourcee that would result from the outsourcing, and the ability of newly empowered impoverished outsourcee workforces to learn the business, clamber up the value chain and eat the outsourcer’s lunch. This appears to have happened in software with India, in solar panels with China and doubtless in other sectors, whilst U.S. innovation is increasingly confined to trivia like “social media.”

<sup>6</sup> Whilst on the subject of productivity, it is obvious that the U.S. has had a productivity growth ‘problem’ for a long time. Real average weekly earnings have never fully recovered after they fell off a cliff around 1973, and household incomes since then have only been propped up by increases in the number of workers per household, i.e., both spouses going out to work. And yet even as late as the late 1990s, Fed chairman Greenspan was able to proclaim a ‘productivity miracle’ that fooled many into thinking that the U.S. was reaffirming its place in the sun: these were after all the years of the tech boom. Yet this turned out to be a mirage: in fact, U.S. multifactor productivity growth over 1995-2000 turned out to be below the post-War average.

<sup>7</sup> It is noteworthy that multifactor productivity also fell sharply at the time of the Volcker disinflation, when ultra high interest rates – themselves only made necessary by previous soft money policies – made redundant much of the capital stock that would otherwise have remained in use, choking off new investment and slowing down productivity growth. Extreme levels of interest rates in any direction are thus damaging to productivity.

Taking these effects together, we can see that lower interest rates have damaging effects – which compound over time to become disastrous in the longer-term - on capital accumulation, output and living standards.<sup>8</sup> These effects come through: (1) the misallocations of capital and long-term decapitalization associated with repeated destabilizing boom-bust cycles, (2) the damaging effects of policy-induced uncertainty, (3) the loss of capital, jobs and innovation overseas, (4) reductions in productivity growth, and, of course, (5) reduced savings rates which discourage the accumulation of capital in the first place.

### **State Intervention and the Financial System**

State intervention also has a profoundly damaging effect on the financial system. An excellent example is government deposit insurance. This creates a well-known moral hazard which encourages banks to take more risks than they would otherwise take and increase their leverage. This weakens the whole banking system. Less well understood is that it creates a race to the bottom, in which banks take more and more risks and become ever more leveraged over time, culminating eventually in the collapse of the banking system. These problems are aggravated further by other policies to support the banking system such as a central bank lender of last resort, the anticipation of bailouts and, of course, Too Big to Fail.

The standard response to these problems is capital adequacy regulation to force banks to observe minimum capital requirements that will, allegedly, protect their financial health. However, capital regulation does not work: the Basel system of international bank capital regulation has shown itself to be a total failure.<sup>9</sup> The system itself is easily captured and manipulated by the banking industry. At the most basic level, this is because the rules are poorly designed by officials who do not understand the banking system: the rules themselves often make no sense, and are easily gamed<sup>10</sup> and often counterproductive.

To give just one example, the rules give sovereign debt a zero weight based on the underlying assumption that sovereign debt is free from default risk. This is self-evident nonsense, as the examples of Greece and many other Eurozone countries demonstrate. It is also counterproductive, because it incentivizes banks to hold government debt in preference to, say, commercial debt or loans to small business, and this is a critical factor driving the current Eurozone crisis. This example illustrates how an obscure regulation might receive little attention when first installed, but can help produce an immense crisis 20 years later. Furthermore, this distorted incentive will increase sharply when Basel III raises capital weights from 8% to about 15%.

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<sup>8</sup> The long-term decapitalization theme is explored further by us elsewhere (Dowd and Hutchinson, 2010, 2011).

<sup>9</sup> The failure of the Basel system is discussed in much greater length by Dowd *et al.* (2011) and Kerr (2011b).

<sup>10</sup> For example, capital regulations are ratings related. So how should a bank deal with an asset portfolio that has just been downgraded? Easy. The bank sells the assets to an SPV that issues two tranches of notes, where the junior piece is sized sufficient to procure an AAA rating for the senior, and will typically be relatively small. The bank then buys both sets of notes and so re-establishes its AAA rating for most of its portfolio.

The result of these and other state interventions is a highly dysfunctional and overpaid banking system, especially as regards the biggest banks:

- *Core activities*: Lending is no longer the banks' core activity. Instead, banks make most of their income from trading – for example, in 2010, the six largest bank holding companies generate 74% of their pretax income from trading (Wilmer, 2011) – and yield-curve riding courtesy of the Fed.<sup>11</sup>
- *Compensation*: Bankers are overcompensated. To illustrate: the average investment banking compensation at four of the top banks was at least six times that of average American worker, and the CEOs of the top six bank holding companies were paid 516 times U.S. median household income, and 2.3 times the average total CEO compensation of the top Fortune 50 nonbank companies (Wilmer, 2011).
- *State support*: The banks enjoy unique privileges – lender of last resort support, massive bailouts, Too Big to Fail, etc. – all underwritten by the state, and are hopelessly dependent on the continuation of current low-interest rates policies.
- *Confidence*: Confidence in the banks has long since evaporated: unsecured interbank lending has all but vanished and the banks are only kept going by state support.

It is important to appreciate that the main driving factor here is the deterioration and ultimately collapse of effective corporate governance in banks, all ultimately due to state intervention (detailed by many commentators, e.g., Dowd and Hutchinson, 2010). The result is a situation in which the bankers have no serious stake in the long-term survival of their own banks; instead, they have become entirely fixated with their own short-term compensation, and if their efforts to make a quick buck bring down their banks, then someone else can sort that out later and the banks can count on another bailout anyway. This incentive structure is the single most important direct cause of the crash.

In essence, the task of the modern investment banker is to construct a personally lucrative witch's brew, encouraged by accounting and regulatory rules designed clearly by scrutineers with little understanding of the financial system. Such concoctions may comprise some or all of the following ingredients:

- Financial models that underestimate the risks involved (e.g., portfolio credit risk models that ignore or under-estimate correlations).
- Financial engineering (e.g., Collateralized Debt Obligations (CDOs), in which claims against underlying pools of loans or bonds are tranching or ranked by seniority and sold off), and derivatives (especially credit derivatives, e.g., CDSs: Credit Default Swaps, or bets on credit events such as downgrades and defaults) to 'slice and dice' risks to maximum personal advantage; particularly helpful in this regard are synthetic positions (e.g., synthetic CDOs which are even more highly leveraged and in which little or no cash changes hands up front: these include CDO-squareds - CDOs in which the underlying pools of loans or bonds are replaced with CDOs – and even CDO-cubeds, in which the underlying pools

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<sup>11</sup> The Fed's interest rate policy allows banks to borrow short-term at close to zero and invest at 3% or so in long-term Treasuries and even more in mortgage-backed bonds, which are now openly guaranteed by the federal government. This enables them to sit back with 3+% spreads leveraged 15 times or so to make a comfortable 45%+ grow return: becoming a yield curve player is far more profitable and avoids all that tiresome bother and risk of lending to small businesses.

are replaced with CDO-squareds). A remarkable example of the economically most destructive engineering was the synthetic CDOs designed to keep the sub-prime machine going. Hedge funds that were betting on the collapse were buying CDS from investment banks who in turn were laying off this risk primarily with AIG. When the underlying subprime borrowing market reached its capacity, the banks responded by creating synthetic subprime which was then sold off to unwitting investors<sup>12</sup> As Michael Lewis puts it rather indelicately, “There weren’t enough Americans with shitty credit taking out loans to satisfy investors’ appetite for the end product” (Lewis, 2010: 143). This explains why the eventual sub-prime losses suffered by the banking system were substantially greater than the volume of the sub-prime market itself.

- Accounting and reg cap practices that allow for fictitious model-based valuations that have no relationship with actual market prices.
- Accounting standards that allow bankers to record unrealized fake profits using mark-to market and mark-to-model valuations and by ‘front-loading’ hoped-for future profits into recorded current profits.
- Compensation practices that allow these fake profits to be distributed as bonuses that cannot later be recovered if valuations were wrong or hoped-for future profits failed to materialize.

Also helpful in this game are two other factors: ratings agencies that are just as conflicted as the banks and use the same dodgy models to assign AAA ratings and hence give apparent respectability to dubious financial structures and, of course, highly gameable Basel reg cap rules.

The resulting Dark Side financing then enables bankers to convert almost any toxic rubbish into AAA rated securities (think subprime and the Gaussian copula, then endlessly recycle such assets through one CDO securitization after another in an alchemical process that seems to convert more and more lead into gold, but doesn’t); to pass risks to counterparties who don’t understand the risks they are taking on (think dozy German Landesbanken or Norwegian pension funds pre-2007) or insure them with counterparties that specialize in the business and then fail when all the chickens come home to roost at the same time (think AIG); to transform expectations of future profits, however unrealistic, into current recorded profits; to run rings around the regulatory system without the latter noticing; to bribe shareholders with high dividends – not to mention buy off politicians - and run off with the rest of the proceeds, i.e., extract the maximum possible rents not only from the financial system, and thanks to government guarantees, from the rest of the economy as well.

These activities reached a fever pitch by the eve of the crisis, by which time banks’ profitability appeared to be at an all time high and by Basel standards the banks were

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<sup>12</sup> They did this by funneling CDS trades into CDOs which were then sold as cash investments to investors, with as usual about the first 80% rated as AAA risk. The way to understand this is to look at the cashflows on the original CDS. The investor buys protection from the investment bank, paying regular premiums in return for a promise of a payment of principal, should the subprime default, equal to some fixed amount minus the value of the defaulted loans. These cashflows were then assigned to a new SPV that issued the same fixed amount of “synthetic sub-prime CDO” whereby the cashflows from the fund mirrored the cashflows from actual sub-prime borrowers. The cash CDO investor would then receive a “coupon” from the CDS premiums and be exposed to a loss of the principal minus the value of the reference loans if (when!) the loans defaulted.

more than adequately capitalized. The banking system then collapsed like a straw hut in the wind when market conditions turned down.

Yet to many insiders, it was obvious for some time before the crisis that the system was heading for collapse. To cut to the chase, if banker compensation is linked to accounting profit, and if accounting rules enable bankers to legitimately account for vast amounts of the cash under their stewardship as profits, then collapse is inevitable: the only puzzle is why it took so long.

Unfortunately, these practices are still continuing and the regulatory response to the crisis is encouraging even more. A case in point is the post-Lehman changes to accounting rules designed to restrict securitization, which – though few observers have yet realized it – have backfired spectacularly by giving rise to a slew of new securitization practices involving innovative collateralized borrowing. This has been Manna from Heaven for those banks that cannot raise unsecured inter-bank finance, which are typically insolvent and which by rights should be out of business already.

To give but one example: the ‘failed sale’ arrangement. This is a repo-like transaction designed to secure finance by granting counterparties hidden hypothecations of prime bank assets.<sup>13</sup> The deal itself is classified as a repo – which is in itself an innocent transaction – but since all banks have substantial repo activity going on as normal derivative and hedging activity, the failed sale deals are very hard to spot individually. With a failed sale arrangement, the collateral pledged is typically of prime quality, the poorer quality having already been pledged to central banks in return for their funding.<sup>14</sup> This type of transaction is damaging in at least two ways:

- It deceives other bank counterparties, who do not appreciate that they cannot recover the prime assets in question, even though they still remain on the bank’s balance sheet. A failed sale transaction is thus essentially fraudulent. Should the bank then fail, creditors (including taxpayers via deposit insurance and other state guarantees) would lose almost everything when they found that they had taken possession of little more than an empty shell.
- The fact that these practices are known to be going on means that banks’ balance sheets cannot be trusted. They could therefore have been tailor-made to destroy confidence and ensure that the next round of the crisis will be highly contagious.

‘Failed sale’ transactions are now rising strongly whilst unsecured interbank lending is disappearing: this is ample indication of the market’s own knowledge as to the insolvency of the banking system.

A related growth industry is in gaming the bailout process itself. These include banks cooking their books to secure bailouts (which was a notable feature of e.g., TARP), recycling their worst assets into securities that can then be sold or repo’d to the

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<sup>13</sup> This is a repo – a standard form of collateralized loan – accompanied by the sale of a repurchase option with the sole intent of hiding the preferment from other bank stakeholders. The trick is that, under the new rules, the repo’d assets never leave the borrowing bank’s balance sheet – that is, the arrangement does not qualify as a true sale; hence the ‘failed sale’ label. So, from the borrower’s perspective, the bank’s balance sheet is apparently unaffected.

<sup>14</sup> This highlights another reason against ‘qualitative easing’, i.e., the central bank lending against poorer quality assets as collateral. Had central banks insisted on the best collateral, banks would not be able to engage in ‘failed sale’ type transactions. Thus, qualitative easing not only leaves the central bank itself vulnerable to losses, but, by allowing ‘failed sales’, exposes other parties too – another instance of the law of unintended consequences.



local central bank, and manipulating QE auctions. After all, from the bankers' perspective, the bailout process itself is just another opportunity to make profits.

It follows from all this that another crash is inevitable. The parlous state of the U.S. banking system is confirmed by Warren Buffett's recent (August 25, 2011) \$5 billion investment in Bank of America. This deal was widely touted as a 'vote of confidence' by commentators anxious for good news, and Mr. Buffett himself portrayed it in a CNBC interview the same day as a vote of confidence in both the bank and in the country. It is, in fact, nothing of the sort. Instead, it is a lender of last resort operation to a desperate 'too big to fail' bank from which he can expect to earn an extraordinary and almost guaranteed coupon return of 15% in an almost zero interest rate environment, confident in the knowledge that his investment is underwritten by the prospect of a future government bailout. If this is good news, then the U.S. is in a truly dire state.<sup>15</sup>

It is no wonder that Bank of England Governor Mervyn King was able to announce a year ago that of all the banking systems it is possible to have, our present system is surely the worst.

### **The Response to the Crisis**

Once the crisis started, the best response would have been to liquidate weak institutions. To quote Andrew Mellon's advice to Herbert Hoover in December 1929, which had worked well in the previous downturn of 1920-21:

Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate. ... It will purge the rottenness out of the system. ... People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up from less competent people.

Such a cleansing out should have been followed by monetary reform (i.e., at a minimum, higher interest rates and a commitment to hard money) and financial reform (i.e., at a minimum, the abolition of federal deposit insurance and state guarantees, and the imposition of extended personal liability for key decision makers: these would have restored sound governance structures and reined in excess risk-taking) to address the underlying causes, combined with major fiscal retrenchment to put public finances in order.

Instead, the actual policy response was much the opposite: the authorities did everything possible to 'stimulate' the economy at all costs and put off any unpleasant restructuring for as long as possible. The Fed funds interest rate was pushed down from 5.26% in July 2007 to almost zero in December 2008, a rate it has since maintained and recently reinforced by a 'commitment' to keep it there till at least 2013. At the same time, the Fed engaged in massive purchases of bank assets financed by printing money (with monetary base growing from around \$800 billion before the crisis to not far short of \$2.7 trillion currently – an unprecedented rise of about 330%) and assorted other support to the financial system (e.g., Too Big to Fail, bailouts, and 'qualitative' easing), whilst the government responded with massive fiscal stimulus and a string of bailouts of its own.

These measures further distorted asset prices, boosting existing bubbles in U.S. Treasuries, financial stocks and the stock market generally and creating additional ones

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<sup>15</sup> An analysis of this deal is provided by Kerr (2011a).

in commodities and junk. They amounted to a huge increase in state intervention in the economy and prevented the financial system and the broader economy from correcting themselves. They aggravated underlying moral hazards that were a major proximate cause of the crisis. They undermined accountability and generated massive transfers to those responsible for the crisis (who had already greatly enriched themselves in creating it) at the expense of everyone else. Even worse was the response of the political establishment, repeatedly bailing them out with taxpayer cash, with further bailouts likely to follow. This goes beyond mere cronyism and amounts to a takeover by the 'banksters' of the political system itself. The situation in most of Europe is much the same, and in some countries worse.

### **The Role of the Federal Reserve**

The Fed's policies continue to be dominated by confusion between causes and solutions, a refusal to face up to structural problems in the economy and an obsession with spending and stimulus. So chairman Bernanke repeatedly maintains that pushing down interest rates is good for the economy, because it encourages investment and boosts asset prices, which increases confidence, encourages greater spending and leads to further economic expansion. He also repeatedly calls for measures to support the housing market and reduce high unemployment, and endlessly warns of the dangers of deflation.

We would take issue with him on every point:

- Lower interest rates were responsible for one boom bust cycle after another since the late 1990s, and each time the Fed's response to the bust has been to lower interest rates again and create an even bigger bubble next time round: the Fed seems unable to learn from its own repeated mistakes. Low rates and the encouragement of house ownership were key factors driving the pre-2007 credit boom so, yes, it obviously follows that what we need to cure this problem is ... even more of what caused it.
- Further, continuing for year after year to provide a negative real risk-free rate of return on savings inevitably reduces saving and in the long run decapitalizes the economy. We would argue that in the U.S. decapitalization has now reached an advanced stage, thus ensuring persistently high unemployment and declining living standards from here on in.
- Greater spending and borrowing are also not much good if the spending is on the wrong things – more housing springs to mind – and excessive. (And, whilst on the subject of low interest rates and excessive spending, anyone any ideas on why savings rates are so low?)
- As for more 'confidence' and 'economic expansion', true confidence needs to be grounded in strong economic fundamentals and a predictable environment – wild policy swings and vast amounts of policymaker discretion don't really help much here – and expansion needs to be in the right areas and sustainable, i.e., have no after-burn.
- As for unemployment, we agree that this *is* a real problem, so why is the Fed creating unemployment with low interest rate policies that encourage the replacement of labor by capital and the migration of U.S. jobs overseas?

- Then there is the deflation issue, so why is the Fed, which claims to support price stability, utterly averse to prices falling but cavalier about them rising, and where was the evidence that deflation ever posed a serious danger anyway? Admittedly, there *would* have been sharp falls in prices in the early part of the downturn – as in 1921 – but this is part of the natural economic correction process.

In any case, there is the deeper question of why is the Fed trying to bring about *any* particular outcomes at all? Issues of prices and resource allocation should be determined by markets, not by some central agency: this is the whole point of a market system.

There is also the Fed's own self-interest. Fed chairmen have an obvious personal interest in getting good headlines, and lower interest rates are more popular than higher ones – just compare the opprobrium experienced by Paul Volcker after he hiked interest rates in late 1979 and 1980 with the glowing approval that followed Alan Greenspan each time he brought interest rates down. The Fed also has its own interests in institutional empire-building, avoiding accountability<sup>16</sup> and exculpating itself when things go wrong, and exploiting crises to its advantage. Again and again, it has used economic emergencies – which it has itself helped create – to expand its powers and responsibilities, which have as a consequence grown enormously since its inception. This happened most notably in the early 1930s, in the early 1980s (e.g., the Depository Institutions Deregulation and Monetary Control Act of 1980) and recently (e.g., huge expansion of balance sheet, Dodd-Frank, etc.). Commenting on the discussions that surrounded the reforms of the early 1980s, Richard H. Timberlake observed that

Fed officials in their testimony to congressional committees persistently and doggedly advanced one major theme: the Fed had to have more power – to fight inflation, to prevent chaos in the financial industry from deregulation, and to act as an insurance institution for failing banks who might drag other institutions down with them. By misdirection and subterfuge, the Fed inveigled an unwary Congress into doing its bidding (Timberlake, 1985: 101).

'The Fed must have more power' was also its major persistent theme throughout the current financial crisis, and very effective it was too. Recent events have only reinforced Timberlake's conclusions from a generation ago:

Its [then] 70-year [now almost 100-year] history as a bureaucratic institution confirms the inability of Congress to bring it to heel. Whenever its own powers are at stake, the Fed exercises an intellectual ascendancy that consistently results in an extension of Fed authority. This pattern reflects the dominance of bureaucratic expertise for which there is no solution as long as the [Fed] continues to exist (Timberlake, 1986: 759).

One must also take account of the fact that the primary practical task of any central bank is to protect the financial interest of its principal client, the government. The government and the Fed have a close working relationship, and the government has a major say in the appointment of senior fed officials and over the legislative environment in which the Fed operates. Since the government's own interest is in low borrowing costs and access to debt finance, this gives the Fed another incentive to lower interest

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<sup>16</sup> For example, the Fed fought hard against efforts to audit it on the self-serving grounds that being audited would undermine its independence (as if, e.g., the Fed's momentous decisions during the financial crisis should be permanently beyond account or as if hiding its mistakes would somehow serve the public interest!). See Kling (2010).

rates. It also makes the Fed the *government's* lender of last resort; moreover, it means that if push ever comes to shove, the Fed will always put its obligation to keep the government financed above *any other* consideration.

The Federal Reserve even distorts discussion of the issues involved, and does so in at least three quite different ways:

- It exploits its advantages of greater research resources and greater technical knowledge, not to mention its ability to wheel out an established 'party line', that gives it the edge over most critics in Congress and the press. It also feeds journalists with own its self-serving spin, throwing bones to those who are sympathetic and freezing critics out. Indeed, Milton Friedman said a long time ago that one of the reasons why the Fed received the good press it did is because it is the source of 98% of all that is written about it (Tullock, 1975: 39-40).
- It distorts monetary research: a recent study by Lawrence H. White suggests that the Fed encourages research favorable to its interests. It tends to 'push' certain research areas and employs and promotes economists with agreeable views, and discourages and even censors critical work.<sup>17</sup> Anyone who enters the field soon learns that criticizing the Fed is unlikely to be career-enhancing and most steer their writing accordingly. White also reports an apparent bias towards pro-discretion articles with very few Fed-published articles arguing for rules: there are almost no favorable published comments about the gold standard, not a single article calling for the elimination, privatization or even restructuring of the Fed, and only one article (by one of us, as it happens<sup>18</sup>) that even *mentions* laissez-faire banking (White, 2007: 344).
- It invents new justifications for its expanding role. Traditional central banking was highly conservative, but as its remit has expanded, the Fed and its foreign counterparts took on a larger and increasingly activist role, especially post 2007, rewriting the central bank textbook as it went along with specious arguments to justify its new policy tools. These included arguments for a zero-interest rate policy, QE, an expanded lender of last resort function<sup>19</sup> and macro-prudential regulation.<sup>20</sup>

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<sup>17</sup> White (2007: 331) cites the case of one academic, whose criticism of a policy decision *fifty years earlier* was censored.

<sup>18</sup> Dowd, 1993.

<sup>19</sup> The classic Bagehot lender of last resort doctrine maintains that the central bank should only engage in lender of last resort support to a (single) distressed financial institution at a penalty rate of interest on first class security, and even then only if that institution is solvent. This doctrine has now been expanded to the point of utter subversion: modern central banks now claim the justification to support (that is, bail out) the whole financial system, even if it is insolvent, with credit provided at below market interest rates against the flimsiest collateral. The central bank is no longer acting as lender of last resort but as lender of first resort to the whole financial system, and it is not so much 'lending' to the financial system as siphoning funds to it in the certain knowledge that it will take on much of its toxicity and absorb major losses itself. Bagehot would turn in his grave: his preferred 'first best' solution was no lender of last resort at all.

<sup>20</sup> This is the idea that regulators can frame regulations to take account of systemic issues. However, existing proposals are little more than hot air, and most implicitly suppose that regulators are able to identify systemic risk problems, second-guess turning points (i.e., beat the market) *and* withstand the inevitable lobbying from the industry to relax standards as the economy booms. Good luck, guys. In any case, the documented inability of regulators to impose even 'simple' capital standards effectively hardly inspires confidence that they will succeed with the extra difficulties associated with macro-prudential. Macro-prudential is, in essence, cloud-cuckoo.

We have reached the point where the U.S. central bank has amassed so much unaccountable discretionary power that its unelected chairman now has more influence over the economy than the President himself. The nightmarish consequences were described by a former U.S. president not well known for his grasp of economics:

The immense capital and peculiar privileges bestowed upon it enabled it to exercise despotic sway upon the other banks in every part of the country. From its superior strength it could seriously injure, if not destroy, the business of any one of them which might incur its resentment; and it openly claimed for itself the power of regulating the currency throughout the United States. ... The other banking institutions were sensible of its strength, and they soon became its obedient instruments ... The result of the ill-advised legislation which established this great monopoly was to concentrate the whole moneyed power of the Union, with its boundless means of corruption and its numerous dependents, under the direction and command of one acknowledged head ... In the hands of this formidable power, thus perfectly organized, was also placed unlimited dominion over the amount of the circulating medium, giving it the power to regulate the value of property and the fruits of labor in every quarter of the Union and to bestow prosperity or bring ruin upon any city or section of the country as might best comport with its own interest or policy.<sup>21</sup>

The gentleman concerned was *not* George W. Bush – the elegant old-fashioned language gives that away - but rather his distant predecessor, Andrew Jackson, and the central bank is not the Federal Reserve but its distant predecessor, the Second Bank of the United States. *Plus ca change*. President Jackson's sentiments about the central bank were sincere and heartfelt: in fact, his 'War' against the Bank was the defining theme of his Presidency, and his veto over the extension of the Bank's charter in 1836 put an end to this earlier U.S. experiment with central banking.<sup>22</sup>

Then, as now, the natural answer to these problems is the same: end the Fed.<sup>23</sup> Such hegemonic institutions have no place in a free market economy. Many of the Founding Fathers understood this too. This is why the Constitution did not give the federal government authority to charter a national bank.

## **The Fiscal Context**

### *The failure of fiscal stimulus*

The government's fiscal response to the crisis was also extreme: it threw all caution to the wind and embarked on a raft of huge deficit spending programs. In the process, the federal deficit rose from under 2% of GDP before the crisis to over 10% now, with the deficit itself currently running at \$1.3 trillion a year; and government official gross debt levels rose from 64% of GDP to over 93%<sup>24</sup>. Such spending is unprecedented in a period

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<sup>21</sup> Quoted in Blau (1947: 14-15).

<sup>22</sup> This led to major improvements in U.S banking over the course of the generation that followed: by the eve of the Civil War, there was a clear trend toward successful free banking systems (Dowd, 1992). Then came the Civil War and the renewed federal intervention that followed in its wake.

<sup>23</sup> The repeated failures of the Fed are well-documented. See, e.g., Timberlake (1986), Dowd (1995), Paul (2009) and, more recently, Selgin *et al.* (2010).

<sup>24</sup> Indeed, Scarbek (2011) points out that by her preferred measure, the debt/GDP is poised to pass the scary 100% level on, appropriately, enough, Halloween 2011.

in which the U.S. is not engaged in a civil or world war: even in the 1930s, the federal deficit only peaked at 5% of GDP and government debt in 1940 was only about 50% of GDP. The result of this spending orgy is that U.S. debt is approaching danger levels; this would seem be confirmed by its recent credit downgrades.<sup>25</sup> A rise in interest rates or further downgrades could then trigger a major financing and even solvency crisis as U.S. debt spirals out of control.

And what did all this stimulus achieve? The answer would appear to be a big stimulus to the government sector and a big crowding out of the private sector. Net private sector domestic investment fell sharply and is still under half its 2007 levels, U6 unemployment rose from 7.9% from its low point in May 2007 to about 20% now, and real GDP is still below its 2007 levels.<sup>26</sup> Or to put it another way, the biggest stimulus in history failed to stimulate.

We should also bear in mind that the GDP measure of economic activity can itself be misleading. This is partly because the measure is highly aggregative, lumping one form of spending with another, regardless of what the spending is actually *on*, so ignoring the structural imbalances within the economy that are at the heart of the crisis. GDP is also misleading because it values government spending at cost.<sup>27</sup> According to this measure, any government spending programs, however foolish – think here of the recent multi-million dollars ‘bridge to nowhere’ in Alaska of a few years back - are always good, simply because their cost is added to GDP. It is the use of this measure that emboldens Keynesians to declare that World War II got America out of the Depression and that stimulus will work if only you make the stimulus big enough. The former claim appears plausible if you look at GDP – after all GDP increased sharply during the War – but the usual conclusion drawn, that a huge conflict is a good thing, actually makes no sense and is besides morally offensive. By contrast, a more sensible measure, GPP (Gross Private Product, or GDP minus the government spending) paints a more credible picture. According to this, the U.S. private economy was recovering strongly shortly before the War, then halved by 1944, before recovering strongly again immediately after the War.

The most recent versions of the ‘war is good for us’ fallacy<sup>28</sup> come from two (we presume, unintendedly) self-parodying suggestions by Larry Summers<sup>29</sup> and Paul

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<sup>25</sup> S&P downgraded the Federal government’s credit rating from AAA to AA+ by S&P in August 2011; Dagong, the Chinese rating agency, downgraded the government’s credit rating twice last year and now gives it a rating of single A.

<sup>26</sup> The failure of these fiscal stimulus programs has been convincingly demonstrated by Bob Higgs on his Independent Institute blog. Leaving aside the point that these programs failed to address the economy’s structural problems, they also failed because of their sheer wastefulness and because of the pervasive uncertainty they created over the security of property rights and prospective investment returns. In both the later years of the New Deal and since the onset of the crisis, this ‘regime uncertainty’ had a crippling effect on private sector investment that seriously undermined the economy’s attempts to recover. See Higgs (1997, 2011).

<sup>27</sup> The GDP measure has also been criticized by Mark Skousen as failing to include intermediate production. He proposes an alternative measure, Gross Output, that takes account of intermediate production and gives a better picture of what is happening in the economy. The use of this measure also supports the argument that it is business investment—not consumer spending—is the driving force behind economic growth. See Skousen (1990).

<sup>28</sup> This is just a bad taste version of the old broken window fallacy, the idea that a kid who breaks a window is doing a public service by creating work for the window fitter who then repairs the window, the

Krugman.<sup>30</sup> In March 2011, Summers suggested that the Fukushima disaster might be good for the Japanese economy because it might boost GDP, much as the earlier Kobe disaster had also (apparently) been good for the Japanese economy. Not to be outdone, a few months later Krugman suggested that the U.S. economy could benefit from an invasion by Space Aliens, the logic being that all the money spent on anti-death ray equipment and Alien bug killers would boost U.S. GDP. However, using GPP, we would immediately recognize Fukushima and the Anti-Alien Defense Program for what they are, i.e., in the first case, a disaster pure and simple, and in the latter case, a colossal if entertaining waste of money.

#### *The longer-term fiscal context*

Back on Mothership Earth we also have to take account of the longer-term fiscal context. The official U.S. debt, high as it is, is merely the tip of a much bigger iceberg: we must also consider the unfunded obligations of the U.S. government – those future obligations it has entered into but not provided for. Shortly before the crisis, Lawrence Kotlikoff estimated these to be a little under \$100 trillion, and his most recent estimates put these at \$211 trillion – more than doubling over five years. To put this latter figure into perspective, it is 15 times the official debt, 14 times U.S. GDP and a debt of \$580,000 for every man, woman and child in the country – and rising fast. As Kotlikoff explains:

This is what happens when you run a massive Ponzi scheme for six decades straight, taking ever larger resources from the young and giving them to the old while promising the young their eventual turn at passing the generational buck.

Herb Stein, chairman of the Council of Economic Advisers under U.S. President Richard Nixon, coined an oft-repeated phrase: “Something that can’t go on, will stop.” True enough. Uncle Sam’s Ponzi scheme will stop. But it will stop too late.

And it will stop in a very nasty manner. The first possibility is massive benefit cuts visited on the baby boomers in retirement. The second is astronomical tax increases that leave the young with little incentive to work and save. And the third is the government simply printing vast quantities of money to cover its bills.

Most likely we will see a combination of all three responses with dramatic increases in poverty, tax, interest rates and consumer prices. This is an awful, downhill road to follow, but it’s the one we are on. And bond traders will kick us miles down our road once they wake up and realize the U.S. is in worse fiscal shape than Greece.<sup>31</sup>

Or, more bluntly, the U.S. is broke: a debt of well over half a million dollars per capita and rising fast cannot realistically be repaid.<sup>32</sup>

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glazier who produces the glass, and all the others who benefit from the knock-on spending. This nonsense was refuted by Bastiat back in 1850.

<sup>29</sup> CNBC interview, March 11 2011.

<sup>30</sup> CNN interview, August 14, 2011.

<sup>31</sup> NPR interview, August 6, 2011.

<sup>32</sup> We should also keep in mind that most individual States of the Union and many municipalities are themselves in dire straits. Estimates put their unfunded obligations at perhaps \$3 trillion, and many are already struggling to pay their ballooning pension obligations, which are financed on a PAYGO basis out of current taxation receipts. Insiders are already betting on which will be the first to default – the front

## The Road to Economic Armageddon

To sum up, state meddling in the U.S. economy has gotten the country to the surreal situation where the banking system is insolvent and kept going only because it is being propped up the Federal Reserve and the federal government, but the Fed is also insolvent and only kept going because it is being propped up by the government,<sup>33</sup> and the government is itself insolvent. Thus, the whole system is insolvent and no insolvent system can last indefinitely. Collapse of the system is inevitable.

The immediate short-term prospects are not too good either. If we look at data since August 2007, we see that average annual monetary growth is between 6% and 11% (10.5% for M1, 6.3% for M2 and 7.5% for the broader MZM); we also see that monetary growth rates stalled in 2009 but turned around in 2010 and are now rising again:<sup>34</sup> M1 at 20%, and M2 and MZM at 10%. Official CPI inflation averaged 2.1%<sup>35</sup> but we estimate that the true CPI inflation rate was around 3.1% or just a little more; the latest official CPI rate is 3.9% and our latest estimate about 5%. Hence, inflation is going up. This conclusion is reinforced if we look at the very rapid growth of the monetary base (an annual average of 27%, now expanding at 30%), which is now clearly feeding through to the broader monetary aggregates, and the real interest rate, which is now close to an historically unprecedented minus 5% or so. Bottom line: watch out for rising inflation in the future.

The Fed now finds itself in a dilemma of its own making and has effectively checkmated itself. On the one hand, the Fed can do the 'responsible' thing from a

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runners being California, Florida, Illinois and Arizona – and municipalities are already defaulting: indeed, Harrisburg PA is filing for Chapter 9 bankruptcy as we write. Needless to add, there is enormous pressure on the Feds to step in and bail them out.

<sup>33</sup> The size of the Fed's balance sheet is now about \$2.7 trillion. With capital at \$71 billion, the Fed has a leverage (assets/capital) ratio of almost 40, which is higher than that of most banks at the onset of the crisis. Even under the safest market conditions, this would be regarded as very improvident. The Fed's capital/asset ratio is therefore just over 2.5%. Were the Fed a 'regular' commercial bank it would be regarded as a self-evident basket case under Basel capital rules. Most of its assets are government bonds, and elementary analysis shows that if interest rates rise by even a smidgeon their value will fall by more than 2.5%, i.e., the Fed will be insolvent. (To illustrate, assuming that the bond holdings have an average duration of 5 years, then a simple duration analysis suggests that it would take only a 0.5% rise in interest rates to wipe out the Fed's capital.) To make matters *much* worse, 36% of the Fed's assets are not regular bonds at all, but mortgage backed securities and similar trash purchased to bail out the rest of the banking system. Many of these are highly toxic and worth only a fraction of their book values, but remain on the Fed's balance sheet at book values because they are guaranteed by the Federal government and its agencies, which are themselves only kept afloat by government guarantees. Consequently, the Fed is *already* insolvent, even using data based on its own privileged and unaccountable accounting practices.

<sup>34</sup> The temporary slowdown in monetary growth was associated with the banks' hoarding reserves and with sharp falls in bank lending and private investment, all of which are now reversing themselves. In effect, QE primed the system for a monetary explosion, and this is now occurring as bank lending picks up.

<sup>35</sup> An interesting question is why inflation was as low as it was. Part of the answer is that much of the new money created went overseas (e.g., as reserves to the Chinese and Indian central banks, as currency in dollarized economies etc.), leading to higher inflation over there rather than in the U.S itself. Part of the answer is that prices were pushed down by the 2008-2009 spending crash. This crash was however only temporary, and will have no discernible effect on future CPI inflation. We should also remember that the official CPI is itself biased downwards due to hedonic price fiddles: we estimate by about 1%, but others (e.g., Shadow Stats) by considerably more.



monetary policy perspective and raise interest rates to bring inflation under control. However, a rise in interest rates would bring the whole house of cards down: it would expose all the unsafe financings of recent years – these would be left high and dry, and quickly fail; it would burst all the bubbles currently in full swing, inflict huge losses on investors<sup>36</sup> and trigger a wave of bankruptcies, especially among financial institutions; and it would set off an immediate financing crisis for governments at all levels and lead to a wave of municipal, state and possibly federal government defaults. It is, therefore, truly no exaggeration to say that the financial system, many non-financial firms, the Fed and the government are all now addicted to cheap money and unable to function without it.

On the other hand, if the Fed persists along its declared path, the prognosis is accelerating inflation leading ultimately to hyperinflation and economic meltdown. The U.S. has already passed the earlier stages of this process. The first stage involved the central bank expanding the monetary base and indicating that further expansions are likely to follow. This sets the central bank firmly on the path to debt monetization (i.e., printing money to buy debt, in this case not just government debt but the bad assets of the banking system as well). The expanding monetary base then feeds through to *increasing* growth rates of the broader monetary aggregates and thence *rising* inflation, both of which are already happening. By this point, real interest rates are in deep negative territory and going south, and the public are visibly losing confidence in inconvertible paper currency.

The next, critical, stage along this path was passed earlier this summer when the Fed committed itself to hold interest rates down at current levels until at least well into 2013, followed shortly after by the announcement of ‘Operation Twist’ to buy up long-dated Treasuries in order to push long-term rates down. The former reassures bond investors that they should not fear capital losses in the near future, and the latter encourages buyers by indicating that long-term bond prices will rise in the near future. These measures further puff up the already grossly inflated bond market bubble, but merely buy a little more time at the cost of making underlying problems even worse. By this point, the only weapon left in the Fed’s armory short of outright monetization is more of the same – the logical extreme being to commit itself to zero interest rates indefinitely and push the whole Treasury yield curve down to zero – to encourage investors and prop up the market for as long as possible, i.e., for the Fed to give the bubble the maximum puff it can. But whether the Fed gives the bubble one last big puff or not, it is only a matter of time before the bubble does what bubbles always do: it will burst.

We therefore have a bond market that is unsustainable and a Fed that has no exit strategy to safely deflate it. Sooner or later, investors will get fed up of lending to the government for a zero or near zero return, especially with rising inflation eroding more and more of the real value of their holdings, and will then want out. More poignantly, the Fed’s zero interest rate policy has created a one-way bet scenario reminiscent of a

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<sup>36</sup> To illustrate the potential losses involved just on bonds alone, the size of the U.S. bond market is \$32.2 trillion. Given an average duration of 5 years, a 1% rise in interest rates would inflict a hit of \$1.6 trillion on bond holders. Moreover, this figure ignores the banks’ exposure on their share of the over \$400 trillion on interest-rate derivatives, on which the banks have mostly long positions that will also take losses when interest rates rise.

beleaguered currency facing a speculative attack. At some point, investors will realize that bond prices can realistically only go down and that the only rational course of action is to sell and, if nothing else, switch into cash or near cash positions.<sup>37,38</sup> They will then stampede for the exits. The market itself is rather like the cartoon character who runs off the cliff and can only keep on running for as long as he is oblivious to the fact that the ground beneath him has gone.

The Fed and the government are defenseless against this prospect, and once the bond market stirs, its revenge will be most unpleasant. The last time the bond market was seriously roused – in 1994 – interest rates doubled and the fiscally much sounder Clinton Administration received a severe kicking. Clinton’s adviser James Carville recalled afterwards: “I used to think if there was reincarnation, I wanted to come back as the President or the Pope or a .400 baseball hitter. But now I want to come back as the bond market. You can intimidate everybody.” Given the much greater scale and higher prices involved, a collapse in the T-bond market would make the mid-1990s look like a picnic. Interest rates would then rise sharply and trigger the collapse of the financial system and of much else besides.

The only way that the Fed could prevent this happening and prop up the bond market is by resorting to its nuclear option, a desperate remedy that is worse than the disease, but one that we fear policymakers would be too weak to resist: it would have to buy up all the federal debt that investors wish to dump or not take up at current prices, i.e., presumably, *all* of it, once the panic gets going. The Fed would then soon find itself monetizing the whole of the federal debt, currently some \$14 trillion plus change. This would involve a rapid expansion of the existing (already over expanded) monetary base of over \$2.7 trillion to, say, \$17 trillion, an expansion of over 600%.

Inflation would then rise very sharply and remaining confidence in the dollar would soon collapse. Foreign holders of both U.S. dollars and dollar-denominated assets would dump them fast, the huge overseas holdings of dollars<sup>39</sup> would be repatriated to add further fuel to the fire and the dollar would collapse on the foreign markets - or at least against those foreign currencies that were not collapsing themselves by then. There would also be a flight from the dollar within the United States itself as Americans switch to other means of payment such as foreign currencies and physical assets including barter. Inflation would then escalate uncontrollably into hyperinflation and the Fed would soon find itself printing money to finance not just the government’s debt, but even its current expenditures as rapidly rising inflation destroyed the efficacy of the government’s tax collection apparatus. In the process, much of the economic

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<sup>37</sup> To spell this out: if you are holding, say, a bond with a duration of 15 years, then the best you can get is a more or less zero return, because yields are zero or near zero and bond prices have little or no scope to rise any further; on the other hand, if interest rates rise, you stand to take a substantial loss (e.g., of about 15% if interest rise by 1%). But if you hold cash, say, you get the zero return either way. It follows that you would be irrational to hold the bond instead of cash, so you would sell the bond.

<sup>38</sup> And, in yet another example of policymakers defeating their own policies, the further down the Fed manages to push long-term interest rates, the starker the scenario becomes. The incentives to buy (i.e., the yield or the prospect of further capital gains) disappear, whilst the incentive to sell (i.e., the prospective capital loss) increases thanks to the lengthening average maturity of government debt entailed by Operation Twist programs.

<sup>39</sup> Recent Fed estimates of the amount of liquid dollar denominated assets that could be dumped at will on the markets come out at about \$12 trillion.

infrastructure – the payments system, the provision of credit, the financial system itself – would disintegrate, and of course the economy would collapse.<sup>40</sup>

Eventually, however, a new monetary system will emerge based on a new currency – most likely, a reformed dollar pegged to a hard monetary asset (and most likely, gold), and the inflation will at last end.

## **And After**

According to one prevailing theory of the cosmos, the universe that we inhabit is but one of many parallel universes, and each plays out a different set of possible future outcomes. Amongst these universes, we can envisage some in which the crisis escalates into political as well as economic collapse and the U.S. descends into chaos. However, we can also envisage others with happier outcomes – we can only hope that these include our own universe! - in which a future Tea Party/libertarian Republican government under a latter-day Andrew Mellon<sup>41</sup> reverses previous policies and resolves the crisis along free-market lines - among other Herculean tasks, stabilizing the currency (and sooner, hopefully, rather than later), successfully presiding over the necessary liquidations and market corrections, resisting pressure for further bailouts, managing a de facto if not de jure government default, cutting back government and putting public finances back on a sound footing.

### *Restore the gold standard/end the Fed*

Amongst these tasks is the restoration of a sound – that is to say, commodity-based - monetary standard, and the natural choice is a gold standard. A gold standard is not without its flaws, but is vastly better than the unmanageable fiat system that replaced it. It would impose a much needed discipline on the issue of currency and on attempts to manipulate interest rates, has a very creditable historical track record in delivering longer-term price stability and the ultimate endorsement, to our way of thinking, that it is anathema to monetary interventionists. The two criticisms usually made of it are that it did not deliver particularly good short-term price stability and that it was prone to periods of deflation. Our response would be that the longer-term price-level it *did* deliver is much more important, and that fears of the damaging effects of deflation are

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<sup>40</sup> This outcome can only be avoided by a reversal to tight money and one naturally thinks of the Volcker disinflation. However, we have already explained that this would trigger an almighty financial crisis. The fragility of the system now is far worse than it was then, and the political will to address the problem nonexistent. To quote Schlichter (2011, pp. 234-5): economic dislocations have “reached proportions that dwarf anything the system had to deal with at the end of the 1970s ... [Recent events] have exposed not only the fragility of a financial system that has grown, thanks to a 30-year diet of new fiat money and cheap credit, to unmanageable proportions, but also the unwillingness to accept its radical downsizing through market forces. From today’s vantage point, Volcker’s policy was a short-term aberration of the paper money system’s innate course towards ultimate collapse. It has postponed the inevitable, but it won’t prevent it.”

<sup>41</sup> Apart from exceptional leadership skills, the key requirement for any such leader is a good sense of Ordnungspolitik – which in this context can be translated as a belief in the appropriate rules for a free market social order. This would include, amongst other things, a belief in hard money and positive real interest rates, and an aversion to deficits and artificial stimulus. In the postwar period, the outstanding example is Konrad Adenauer, whose Ordnungspolitik laid the foundations of Western Germany’s remarkable economic success.

much exaggerated, i.e., the deflation ‘problem’ is largely a bugaboo fed by misinterpretations of the 1930s and the earlier ‘Great Depression’ that lasted from the 1870s to the mid-1890s.

We would also suggest that the new monetary system needs to be a fully automated one that manages itself and this requires putting an end to the Fed. There would then be no U.S. central bank to undermine the new gold standard by meddling with it, and the gold market itself would be completely free.

There is however the difficult question of whether a gold standard should be adopted unilaterally or collectively. Most likely, as after Britain’s return to the gold standard in 1819 under the great Lord Liverpool, the adoption of a gold standard by the United States would in due course lead to its trading partners joining it, as they came to appreciate its benefits, and thence in time to a new international gold standard. However, given the exchange rate disruption that would occur if the United States adopted a gold standard but its major trading partners did not, the best way forward would be for the United States to convene an international conference with a view to restoring an international gold standard involving all major trading countries. Such a proposal will inevitably bring to mind the previous such conference – the Bretton Woods conference in 1944 – which laid the foundations of the eponymous international monetary system that lasted until the early 1970s. However, the Bretton Woods system was a (mis)managed system that was a gold standard in name only, with other currencies tied to the dollar and the dollar to gold, a heavily regulated gold market, widespread exchange controls and the establishment of two international financial agencies, the IMF and the World Bank, whose mandate was to meddle.

By contrast, we are recommending a bona fide gold standard, a free gold market, no central banks, no exchange controls and the abolition of both the IMF and the World Bank, neither of which has any place in a free market. The role model of this new system<sup>42</sup> is not the failed Bretton Woods system, which failed precisely because it was a ‘managed’ system, but the early free-banking gold standards, such as those of early 19<sup>th</sup> century Scotland or Canada a little later, which were effective precisely because they were close to being free of damaging intervention by the state and its agencies.

The gold standard not only has a large (and growing) body of support, and may be inevitable anyway.<sup>43</sup> Indeed, there are numerous indications that a gold standard is already spontaneously re-emerging: an article by Ambrose Evans-Pritchard in the London *Daily Telegraph* of July 14<sup>th</sup> this year even announced the ‘return of the gold standard as world order unravels’. Banks such as Austria’s Raiffeisen Zentralbank now offer clients gold-based accounts, and others are offering gold ATM machines: one the obvious next steps are private gold coinage and gold-based electronic payments media. On the wholesale side, the SWIFT international payments system now allows payments in gold: these indicate that the wholesale payments infrastructure of a gold standard is

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<sup>42</sup> We prefer to call it the Liverpool system, not something inauspicious such as ‘Bretton Woods II’: if anyone person deserves the accolade of being the true author of the classical gold standard, it is Liverpool. This said, the gold standard that he introduced was in reality a cleaned up version of the older system that had been suspended in 1797 because the discipline it imposed was frustrating William Pitt’s efforts to finance his war against revolutionary France.

<sup>43</sup> Even skeptics are now feeling the pressure to discuss the ‘G’ issue. A good example is World Bank President Robert Zoellick, who last year described gold as the ‘elephant in the room’ and acknowledged that central banks needed to at least monitor the price of gold.

already being put in place. The next stage would be gold invoicing and leading to the development of gold money markets and gold bond markets reminiscent of the development of the Eurodollar markets half a century ago.

Within the U.S., Utah has already passed a law to repeal its capital gains tax on gold and silver coins it will recognize as legal tender, 12 other states are considering similar laws and there is currently before Congress a proposal for a Sound Money Promotion Act sponsored by Senators Jim DeMint (R-SC), Mike Lee (R-UT) and Rand Paul (R-KY) that would remove the federal capital gains tax from gold and silver monetary transactions. British MP Steve Baker plans to introduce a similar Bill in the UK. In Switzerland, there are moves to establish a Gold Swiss Franc and allow free gold coinage. Within the Islamic world, Indonesia has already re-established a gold dinar, and in Malaysia, the states of Kelantan and Perak have re-established both the gold dinar and the silver dirhem.<sup>44</sup> And in Zimbabwe, still smarting from its experience of hyperinflation, the central bank has recently proposed a gold-backed Zim dollar. To quote its governor, Dr. Gideon Gono: “The world needs to and will most certainly move to a gold standard and Zimbabwe must lead the way”.<sup>45</sup>

#### *Fixing the Financial System*

Also needed are reforms to put the financial system on a sound long-term basis, and three in particular stand out:

- Reforms to restore effective corporate governance in financial institutions: at a minimum, these should involve extended liability for shareholders and extended personal liability for key decision makers; the ideal however would be to roll back the limited liability privilege in banking. Such reforms would rein in most of the currently out-of-control moral hazards that exist within financial institutions and so restore tight governance mechanisms and effective risk management.
- The abolition of federal deposit insurance, capital adequacy regulations and interventionist agencies such as the SEC: this would establish a free market in financial services and incentivize financial institutions to maintain their own financial health; this in turn would rein in moral hazards within the financial system, encouraging banks to lend conservatively, maintain high levels of capital and protect their own liquidity.
- Reformed accounting standards: the U.S. needs reliable accounting standards that are principles-based (*not* the current plethora of thousands of pages of rules of current U.S. GAAP) and ensure that any reported profits are ‘true’ realized profits generated (and *not* ‘fake’ profits generated by highly gameable mark to model valuations disconnected from market prices): a good role model here would be U.K. GAAP before the U.K. unwisely adopted IFRS accounting standards in 2006.

#### *A New Constitutional Settlement*

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<sup>44</sup> Both the old dinar and the old dirhem lasted many centuries – and highly successful they were too – and have roots going back through the Caliphate and, before then, to the Byzantine and Roman Empires. Next to them in historical perspective, the venerated British gold sovereign is a mere parvenu.

<sup>45</sup> Quoted in *New Zimbabwe News*, May 15, 2011.

Going well beyond such measures is the need for a new constitutional settlement that reflects the lessons to be learned, of which the key lesson is simply that governments and money don't mix. Central to this is therefore the need for a total separation of the state and the monetary and financial systems. This can only be achieved by a 'free money' constitutional amendment. To quote Henry Holzer writing at the height of the last major U.S. inflation:

To accomplish its purposes, that amendment cannot be a half-way measure. Either the government can possess monetary power, or it cannot – and if it cannot, the constitutional amendment must sweep clean. *The monetary powers delegated to Congress in the Constitution must be eliminated, and an express prohibition must be erected against any monetary role for government.* (Holzer, 1981, p. 202; his italics)

We would go further: this amendment should also prohibit government bailouts, government chartered financial institutions and government financial guarantees of any sort, including those associated with deposit insurance and pension schemes. This would help prevent the future reintroduction of deposit insurance and or new intergenerational Ponzi schemes such as government PAYGO pension schemes or unfunded commitments like a future Medicare. We would also recommend a balanced budget amendment to rule out future deficit finance: these reforms would force governments to live within their current means.<sup>46</sup> We should heed Thomas Jefferson's advice, "To preserve our independence, we must not let our rulers load us with perpetual debt."

The medicine might seem strong, but the disease has almost killed the patient – and history teaches us that anything less would leave in place the seeds from which a new catastrophe would doubtless emerge in the future.

As for the controversy over the state theory of money with which we started, we can surely now regard that as settled. To put Keynes on his head, we can say, beyond the possibility of dispute, that all civilized money is a creature of the market and that the only serious threat it has ever faced is that of predation by the state. It is just a pity that we had to learn this lesson the hard way.

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<sup>46</sup> The dangers and indeed unsustainability of deficit finance were pointed out long ago in a classic study by Buchanan *et al.* (1978). Once again, it is reassuring to see how the markets are ahead. With government defaults looming across the developed world, markets are already marking down many governments' debt, and we can envisage that such debt will have a tarnished reputation for a generation or more. This will pressure governments to live off their current taxation income, and this would have many benefits: government would be cut back, investors seeking safe returns would look to stable private sector investments; big infrastructure projects would be financed by the private sector and hence be better chosen and better managed. Even so, inserting a stake through the heart with a constitutional amendment would help ensure that the government debt monster does not come back to life to haunt us again –or at least not for a couple of generations or so.

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