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Instability at the Fed

The Federal Reserve responded to the 2008 financial crisis with three rounds of quantitative easing and eight years of setting rates at zero. Rates at zero—which means negative in real terms—causes projects that make no real economic profit to appear to be profitable and marginal projects to appear to be robust. As asset prices and skyscrapers surged from the ashes of 2008, the central bank became nervous, prompting Fed chairman Powell to warn last summer:

> In the run-up to the past two recessions, destabilizing excesses appeared mainly in financial markets rather than in inflation. Thus, risk management suggests looking beyond inflation for signs of excesses.

In other words, asset prices matter more than the prices of consumer goods.

The Fed began raising rates in December 2015 and has tightened ten times since then. In September 2018, the Fed signalled it was going to raise rates three more times in 2019. By December it planned to hike twice in 2019. Four weeks later, the number of hikes was down to zero. Most recently, the Fed announced it was going to end the balance sheet roll off by September 2019.

The press attacked Powell for caving to President Trump. The president recently interfered with the independence of the central bank, declaring: "I'd like to see the Fed with a lower interest rate. I think the rate's too high," earning him even more opprobrium from hyperventilating left-wing journalists. "Like nearly everything he touches, Donald Trump is now in the process of thoroughly debasing the Fed, one of the few still-respected institutions left in Washington," rages Vanity Fair's William Cohan.

Down the memory hole goes Lynden Johnson's inquiry to his attorney general whether he could fire Fed chairman McChesney Martin for raising rates: "How can I run the country and the government if… Bill Martin is going to run his own economy?" And Nixon's demand that the Fed increase money supply growth prior to the 1972 election: "You're independent (laughter), independent (laughter). Get it up!" he ordered Fed chairman Arthur Burns. And Carter's whining about Volcker's rates: "Our trepidation about Volcker's appointment was later justified, when the Federal Reserve under his leadership … [was] a negative factor in my 1980 reelection campaign." And Reagan's Chief of Staff's message to Volcker before the 1984 election: "The president is ordering you not to raise interest rates before the election." And Bush's public shaming of the Fed in his 1991 State of the Union Address: "Interest rates should be lower—now." And Clinton:

> There's an impression—widely held and mistaken—that Clinton simply stood by and accepted this change in direction by Greenspan and the Fed [of raising rates above 3%]. Hardly. The President was livid. He wanted nothing so much as to attack the Fed in public statements, just as Bush had done. But his economic team urged him to hold off. "We had to restrain him," says Alice Rivlin, former director of the OMB.*

Clinton was more effective than the others: instead of bleating in public, he undermined the Fed by appointing as governors radical left-wing ideologues who would advocate unrestrained money printing, such as Alan Blinder ("the harm that inflation inflicts on the economy is often exaggerated") and Janet Yellen ("when it comes to calling for tough trade-offs, to me, a wise and humane policy is occasionally to let inflation rise even when inflation is running above target").

Trump is now following Clinton's lead by nominating right-wing ideologue Steve Moore to be a Fed governor. In a recent *Wall Street Journal* opinion piece, Moore called the Fed's rate increases:

> inexplicable … sending the price of commodities tumbling by 15%, including everything from oil, soybeans and orange juice to steel, lumber and copper. Stocks fell by the same amount in nominal terms, pushed down by deflation. The market turbulence wasn't a reflection of weakness in the real economy. It was all the Fed's doing. Even the consumer-price index has been flat or slightly negative for the past three months, and inflation remains way below the Fed's 2% target.

"Serious economists" of all stripes have bewailed Trump's pick: "He does not have the intellectual gravitas for this important job," complains Greg Mankiw, a Harvard professor. "Steve knows absolutely nothing about the Federal Reserve or monetary policy," charged supply-sider Bruce Bartlett. "It could spawn a global financial calamity," rants hysterical columnist Robert Samuelson. Clinton could appoint partizans because he was a statesman, but Trump is a demagague, and Brutus is an honorable man.

Moore's real, unpardonable sin is that he does not clothe his politics in bureaucratic language (the only useful skill a degree in economics imparts). But his text above deftly identifies precisely the conflict at the heart of Fed policy: whether to manage asset prices, per Powell's quotation above, or the prices of consumer goods. The fact that Moore is completely wrong is hardly a disqualification for appointment—the history of the Fed shows that his view is, in fact, a prerequisite.

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* Martin, Justin. 2001. *Greenspan: The Man Behind Money*. Cambridge, Mass: Perseus Pub.: 205.

The Glass-Owen Federal Reserve Act of 1913 was a political compromise between Wall Street Banks and left-wing progressives, such as Robert Owen, the part-Cherokee senator from Oklahoma. The Act, designed in large part by Banker Paul Warburg, permitted the Fed to monetize "notes, drafts, and bills of exchange arising out of actual commercial transactions … [and only those that] have a maturity at the time of discount of not more than ninety days"—in other words, commercial invoices. Instruments associated with fixed capital, the "carrying or trading in stocks, bonds or other investment securities," were prohibited. It would be difficult—some would say impossible—for a bank to create or sustain a bubble by monetizing 90-day commercial invoices.

But Owen had a very different goal for the central bank, shaped by his personal history. He had been born to a railroad baron who would be ruined in the Panic of 1873. Through ambition, work, and connections, Owen rose to become a banker and was himself nearly ruined in the Panic of 1893. His journey from wealth to poverty to wealth and nearly back again created a lasting enmity for the market, that unstable and unjust cauldron of animal spirits that only the power of the state can subdue.

In 1899, while still a banker, Owen explained his proposal: "That the currency could be quickly and safely expanded by issuing Treasury notes against standard securities put up as collateral with the Treasury of the United States. In this manner the sudden withdrawal of deposits and the shrinkage of the narrow margin of currency available to the banks could be supplemented as above stated without forcing into liquidation, at such an unfortunate time, any borrower."

As a quick review of Austrian business cycle theory, the way the fractional reserve banking system functions is that the banking system takes a $1 demand deposit and—through the fractional reserve multiplication process—lends out $10 or $20 at term against assets such as real estate and industrial loans. This manufactured credit bids on capital assets, increasing their price. Since the price of an asset must be equal to the discounted sum of its expected cash flows, rising asset prices signal a falling discount rate. The further into the future cash flows lie, the more affected their values are by discount rates, which means that a falling rate boosts especially the value of long-term projects (such as real estate). Rising values of long-term capital items encourage overinvestment until overcapacity causes cash flows to fall short, which then prompts malinvestments to default on their loans and liquidate, bringing on a banking panic. This cycle has been occurring for at least two thousand years, if not longer.

Owen's proposal would mean that every time the market tried to liquidate malinvestments created in the boom, the government would step in and save them. The result would be ever more malinvestment until the structure of economy became so impaired that the government would not be able to forestall collapse.

Warburg's design made the Fed ill prepared to contribute to a bubble, but Congress quickly expanded the character of assets it could hold in order to assist the war effort, resulting in the enormous stock market bubble of the late 1910s. The *Wall Street Journal* on April 23, 1919, wrote under the headline "Speculation renewed in rails—Creditor roads and oil prospects favored": "The public is now apparently crazed by speculation, and it is anyone's guess where stock prices will go." Asset prices continued higher, and in July the *Journal* asked in an article titled “Speculation Promoted from Washington”: “Everywhere the inquiry is: ‘When will the rise in stock market prices cease; what is the cause of this continual advance?’”

In May 1919, with the stock market nearing its bubble high, a crazed Senator Owen was calling for lower interest rates to stimulate economic activity. But the Fed grew cautious, admitting in its 1920 annual report there had been an “unprecedented orgy of extravagance, a mania for speculation, overextended business in nearly all lines and in every section of the country.” The Fed finally raised discount rates from 4 to 7% “with the object,” according to the board, “of bringing about more moderation in the use of credits, which a year ago were being diverted into all kinds of speculative and non-essential channels.” Manufacturing production fell 20%, commodities by 43%, the Dow Jones Industrial Average by 47% as malinvestments liquidated.

Senator Owen blamed the crash on the Fed:

> The Federal Reserve Board is the most gigantic financial power in all the world. Instead of using this great power as the Federal Reserve Act intended that it should be used, the Board abdicated.… In addition to restricting credit, these bankers increased the interest rates they sought to make, and succeeded in making the dollar buy more of everything but credit. Various lines of business were refused credit absolutely. People had invested hundreds of millions in automobiles, but the men in the automobile industry found their credit cut off. Other lines of business were also made victims through the same unreasonable and unnecessary effort toward general deflation.

In other words, the Fed failed to support overinvestment in capital-intensive, long-term projects (like steel and automobile manufacture) that Owen thought should always carry a federal guarantee. Owen may have lost the battle in 1920, but he won the war.

The early 1920s saw the rise of Keynes and Irving Fisher and their proposal that central banks should act to stabilize prices (as opposed to Warburg’s vision that the Fed should be confined to regulating commercial credit, allowing the gold standard to determine prices). The Fed embraced this view as early as 1921.* The problem was that the Fed chose to stabilize prices near the World War I bubble highs, preserving overcapacity in capital-intensive, long-term industrial projects.

From October 1921 to mid-1922 the Fed tripled its holdings of government securities to mitigate the effects of the 1921 panic in an early version of quantitative easing. It worked: industrial production surged 49%, which supported commodity prices by creating artificial demand for the overcapacity built during World War I.

Industrial activity and commodity prices began to soften in 1923, and so the Fed engaged in a second round of asset purchases through the end of 1924, igniting the Florida land bubble. The effects gradually wore off, and by mid-1927, wholesale prices had fallen 14% over the previous eighteen months.

* In 1926 congressional hearings, Governor of the Federal Reserve Bank of New York Benjamin Strong was asked: “Do you think that the Federal Reserve Board could, as a matter of fact, stabilize price level to a greater extent than they have in the past by giving greater expansion to market operations and restriction or extension of credit facilities?” to which he responded: “I personally think that the administration of the Federal reserve system since the reaction of 1921 has been just as nearly directed as reasonably human wisdom could direct it toward that very object.” Council on Foreign Relations, and C. P. Howard. 1928. Survey of American foreign relations, 1928. New Haven: Yale University Press, for the Council: 214.

Even though the stock market remained 151% above the 1921 bottom, consumer goods prices needed more stabilizing, so the Fed launched a third round of asset purchases. This time the stock market went crazy, rising 137% over the ensuing next two-and-a-half years, quintupling from start to finish.

And yet, by September 1928, wholesale prices were falling again due to overcapacity that Fed policy had saved from liquidation. According to its new-found stabilization mandate, the Fed should have engaged in more easing. But Benjamin Strong, the principal author of the stabilization policy, died in 1928, and power shifted to those appalled by out-of-control asset markets—it turns out "price stability" becomes nonsensical when various prices start heading in different directions.

In February of 1928, the Fed initiated a campaign to control asset prices by raising its discount rate, just as it had in 1920. Reprising Owen's mad condemnation of rising rates, Keynes warned: "If too prolonged an attempt is made to check the speculative position by dear money, it may well be that the dear money, by checking new investments, will bring about a general business depression." Keynes was right in a sense, as Owen had been: if the Fed had printed more money instead of raising rates, liquidation could have been kept at bay longer; but it would have also encouraged more speculation in nonproductive lines of business and made the ultimate adjustment worse.

Stocks and rates marched higher until both peaked in September 1929. The stock market fell 40% over the next two months as malinvestments began to liquidate, which ushered in the banking panics of 1931 and 1933.

Monetarist Milton Friedman famously rejected the Austrian business cycle theory view of the 1920s bubble and bust: "Far from being an inflationary decade, the twenties were the reverse," therefore, "I have no reason to suppose there was any over-investment boom … during the 1920s." In other words, like Keynes, Friedman thought only the prices of goods matter and that the central bank abdicated its responsibly to stabilize them.

What Friedman and Keynes missed is that the market wanted prices to fall, and not just because of overcapacity: investments in the assembly line, electricity, the telephone, tractors, and automobiles caused productivity to soar—real output per non-farm worker rose by 25% from 1922 to 1929—and cheaper manufacturing should have lowered prices materially. But, as Hayek wrote in 1932:

> Instead of prices being allowed to fall slowly, to the full extent that would have been possible without inflicting damage on production, such volumes of additional credit were pumped into circulation that the level of prices was roughly stabilized.… Whether such inflation [i.e., monetary expansion] merely serves to keep prices stable, or whether it leads to an increase in prices, makes little difference. Experience has now confirmed what theory was already aware of; that such inflation [i.e., monetary expansion] can also lead to production being misdirected to such an extent that, in the end, a breakdown in the form of a crisis becomes inevitable.

Let us skip forward several decades to see how this tension between managing goods prices and asset prices played out in the internet stock market bubble. By the late 1990s the market for technology stocks had gone crazy. Companies with small revenues and large losses were worth billions of dollars. The average first-day gains for newly listed companies was 271% in January 1999, 145% in February, 146% in March, and 119% in April.

But in February 1999, Fed chairman Greenspan's primary worry was that the prices of consumer goods were not rising fast enough: "We cannot find inflation in either the CPI or the PCE index…. How is it possible, first, for hourly compensation growth to be flat or falling in an ever-tightening labor market? … The evidence, anecdotal and otherwise, suggests that the explanation lies in pressure coming from employers, who have apparently lost virtually all pricing power."

Greenspan understood the two reasons why employers were losing pricing power, the same two as in the 1920s. First was overcapacity: "Tradable goods prices are being significantly held down by excess world capacity." Second was technological progress: "There has been a very interesting pickup since 1994 in the average rate of price decline in the high-tech area of the economy … and the most recent data suggest that high-tech prices are dropping at an annual rate somewhere in the area of 17 to 18%. Thus, even though that sector's share of GDP is only a few percent, these price declines are having an appreciable influence on the overall inflation rate."

In February 2000—a month before the peak of the one of the largest stock manias the world has ever seen—Greenspan was still worried about low inflation in the prices of consumer goods: "If we hold [M2 money supply] to where we are now in the context of rising productivity and rising real growth—that is, keep nominal the same—we will then get declining long-term prices." The obvious solution was to increase the rate of money supply growth: "We can say [to the public] that we are trying to find the range for price stability and that we envisage that potential growth has risen. And, therefore, other things equal, the ranges [of money supply growth] should go up if our objective remains where it was several years ago…. [U]nless there is a change in income velocity … it's an arithmetical truism." Yes, in February of 2000, with the NASDAQ up twelvefold over the previous nine years, Greenspan wanted to increase the growth rate of M2. And they call him "Maestro."

Experience has dramatically confirmed the Austrian business cycle thesis over and over, yet the FOMC under Greenspan completely ignored it: "There's no guarantee that even if you get a 1929, you'll end up with a 1932." Future Fed chairman Bernanke made Greenspan's argument in more academic terms: "Our reading of history is that asset price crashes have done sustained damage to the economy only in cases when monetary policy remained unresponsive or actively reinforced deflationary pressures…. Importantly, for present purposes, [the inflation-targeting approach] implies that policy should *not* respond to changes in asset prices, except insofar as they signal changes in expected inflation." After all, the state could always adhere to Owen's 1899 proposal to print money to preserve overcapacity and stabilize the prices of goods, fighting their natural tendency to fall.

Greenspan did finally raise rates, but only because he worried those who had made money in the market would start spending it and push consumer prices higher, the so-called "wealth effect":

> The only way to eliminate the wealth effect, which has to be eliminated, is for the discount rate—the market interest rate used by investors to calculate the present value of expected earnings—to rise.… [T]he question is how we can facilitate that rise.… I think the crucial point here is that we express and continue to express a general view that our goal is basically to move the funds rate up consistently.

The market quickly cracked, and, suddenly, instead of a wealth affect pushing prices higher, there was a negative wealth effect. Greenspan lowered rates from 6.5% to 1%. The stock market didn't recover quickly enough for the central bank's liking, so Vince Reinhart, secretary to the Federal Open Market Committee, warned—in public: "If asset prices do not adjust sufficiently to stimulate spending, then open market purchases of longer-term Treasuries, in sizable quantities if necessary, can move term premiums lower." That was in 2003. Before the Fed could implement QE, however, the 1% rates ignited the housing mania.

Given this history, how is Steve Moore not qualified to be a Fed governor? Instead of being a left-wing ideologue who wants to print money, he is a right-wing ideologue who wants to print money: however much is required to prevent commodity prices from falling even if the free market dictates they should; and so what if the result is crazed asset prices and forestalling the liquidation of malinvestments? He is firmly within the tradition of Owen, Keynes, Friedman, Greenspan, and Bernanke.

"Serious" economists now regard the Fed governors who raised rates in 1920 and 1929 as villainous ignoramuses, and it is in their tradition that Powell seems to have been treading, at least until the market broke. Powell only *seems* to be a liquidationist because he wanted to constrain the insanity of the asset markets. He is probably closer to Greenspan's stop-printing-when-you-get-the-wealth-effect-and-then-start-printing-when-you-get-the-negative-wealth-effect ideology.

Bernanke executed Reinhart's plan in 2008, as will Powell and Moore, as would every other non-Austrian school economist as soon as asset markets start to fall in earnest. The only distinction among them is when to start printing, how to do it, and how much to do per episode (matters on which the Fed's staff make most of the determinations, or at least present the menu). And, let us not forget that the Fed's self-imposed mandate is no longer to stabilize consumer goods prices but to keep them rising at 2% per year, which requires printing at an even faster rate.

The FOMC announced after its latest meeting on March 20 that the median fed funds forecast of its members was 2.6% through 2021, with the lowest forecast being 2.37%. Meanwhile, the futures markets project a 50% probability that the fed funds rate will be less than 2.25% within a year. In other words, the market is betting the Fed is going to heed Trump and Moore's demand that it cut, which leads to a thought experiment: imagine the Fed had begun cutting rates in early 1920 or 1929 or 2000 instead of raising them. Owen and Keynes and Friedman and other theorizers argue that doing so would have prevented the debacles. But any practical person operating in business or finance knew that those bubbles were due for a crash—long overdue. Rate cuts at the right time may possibly have extended them and made them worse (as, indeed, happened from 2003–2006), but the crash was coming one way or another.

Anyone operating in today's financial markets—witnessing the new real estate boom, the "levered loan" orgy, the egregious sovereign debt bubble, the stock market bubble, the private equity mania, the sub-prime auto bubble, the student loan bubble—knows (practically if not intellectually) that the Fed's "stabilization" policy will result in disaster, bring more QE, tank the dollar, and send gold soaring. If the Fed cuts now, it may be able to delay the next crisis, but that will only make it worse.