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The Cato Institute Excommunicates Milton Friedman

By: Christopher T. Mahoney – May 14, 2013

It is possible to be both an orthodox libertarian and an orthodox monetarist. I know this because the pope of both religions was the same person for almost half a century: Milton Friedman. And indeed Friedman remains a major saint in both churches. Friedman believed that there is no conflict between believing in limited government and in the prudent administration of a fiat money currency system.

While many libertarians reject fiat money and central banking, this is not a tenet of the religion, and membership the Anti-Central Bank Society is not mandatory.

I can understand, in a philosophical sense, why many libertarians reject central banking and embrace unregulated monetary arrangements involving "free banking" and competitive currencies. They view the central bank as an appendix of the state and, as such, an enemy of property and wealth. They believe that the state uses the central bank as a mechanism to engage in crypto-taxation, debt monetization and wealth destruction. Since libertarians want to minimize the state and to allow markets to operate, they prefer free banking and competitive currencies, including gold. Free banking and competitive currencies do not require a central bank, as the US demonstrated during the 19th century.

Philosophically, I can agree with the desire for a market-based, self-regulating monetary policy. As a student of economics, however, I see such an arrangement as impractical in the extreme. Friedman explained over fifty years ago that the gold standard caused repeated deflations, panics and depressions. He spent decades of his life arguing that economic depression is always and everywhere a monetary phenomenon.

While Friedman did not live to comment on Market Monetarism, he is its godfather nonetheless. He would be appalled at the idea that the libertarian movement would actively oppose the concept of an independent central bank pursuing policies intended to maintain moderate growth and inflation. Friedman understood that inept monetary policy could lead to Keynesian experimentation and the expansion of the welfare state.

It troubles me to see the "sound money" movement gaining influence within the libertarian movement and its institutions. An example of this malign influence can be found today at the Cato Institute whose new president, John Allison, is described by Wikipedia as a "staunch opponent of the Federal Reserve".

My discomfort was increased when I came across Mr. Allison's latest dissertation in the May/June issue of the Cato Policy Report, titled "The Federal Reserve's Unsound Policies". I read his piece with mounting annoyance. Mr. Allison is a fine man and a sound commercial banker with an excellent track-record. But, like many commercial bankers, he does not understand monetary policy (and that includes many regional Fed board members). Mr. Allison proceeds from a set of a priori principles to make statements about Federal Reserve policy that betray an infirm grasp of basic monetary theory.

More in sorrow than in anger, I offer below Mr.Allison's paper accompanied by my critical commentary (in italics):

The Federal Reserve's Unsound Policies

The Federal Reserve is increasing the long-term risk in our financial system through both its monetary and regulatory policies. It is simultaneously redistributing wealth from moderate-income savers to high-income households and laying the foundation for another housing bubble.

From 1914 until 2007 the Fed's balance sheet grew to $900 billion. Since 2007 the balance sheet has exploded to $3.2 trillion and is growing $80 billion per month. The Fed's capital ratio is currently 1.3 percent, while the average capital ratio of the largest banks is 8.0 percent. The Fed fails its own stress test and should be forced to shrink by its own standards. The risk in the financial system is not large banks, but the Fed itself.

CM: The Fed poses no credit risk to the financial system because it can print whatever it owes. As a monetary authority whose liabilities are money, the Fed requires no capital, although its ability to print money out of thin air is an asset of unlimited value. If the Fed were a commercial bank, its Tier One Ratio would be very high because its assets are low-risk (treasuries and agencies). It is also extremely profitable.

The Fed's balance sheet has been radically expanded to hold down interest rates by buying Treasury and Freddie/Fannie bonds.

CM: The Fed's balance sheet has been expanded in order to prevent a contraction in the money supply, and in an effort to maintain nominal growth. Without the Fed's efforts, M2 and nominal GDP would have sharply declined after the Crash, as they did after 1929. The Fed's post-Crash policies have prevented another depression. For an alternative scenario, see the eurozone.

This has significantly expanded the lending capacity of banks. Increasing the level of bank reserves has the same effect as "printing money." If the economy starts to grow, either inflation will increase as money velocity accelerates or the Fed will have to withdraw the excess reserves, which will result in rapidly rising interest rates and major losses for bondholders.

CM: The object of Fed policy is to induce economic growth, which has succeeded despite falling velocity. When velocity rises, as it will, the Fed will be able to withdraw reserves without high interest rates. If the Fed acts prematurely, we will have another recession.

If the Fed does not shrink its balance sheet, the economy could be stuck in very slow growth as the government consumes an increasing share of the economy, as has happened in Japan.

CM: The Fed's goal is full employment and it policies are geared to create sufficient growth to meet that objective. The Fed's balance sheet and the federal government's share of the economy are unrelated phenomena. In fact, the government's share of the economy has been shrinking as the Fed's balance sheet has been growing. Federal outlays as a % of GDP have declined from 25% in 2009 to 22.5% in 2012, and this trend is likely to continue for some time.

Since the U.S. dollar is the world's reserve currency, these actions have created a global currency trade war. This currency trade war causes misallocation of capital and lowers the global standard of living just like a trade war based on raising tariffs. Instead of production being driven by real competitive advantages and efficiencies, fluctuating currency values are causing a sub-optimization of resources. Every country wants the "cheapest" currency to make its export industries more competitive.

CM: Many of the world's central banks are seeking to prevent deflation via QE, which is intended to grow the money supply and the economy, and thus to raise nominal incomes. If successful, such policies raise living standards, while deflationary policies lower standards (see: Spain). Growth-oriented monetary policies can result in exchange fluctuations versus other currencies. Generally speaking, the currencies of central banks pursuing deflationary policies will appreciate against the currencies of central banks pursuing growth-oriented policies. In a world of freely-floating exchange rates, growth policies resulting in currency depreciation do not constitute a "competitive devaluation", and such policies are not a "trade war". The best measures of the efficacy of a country's monetary policies are its rates of economic growth and unemployment. By these measures, the Fed's expansionary policies are substantially outperforming the ECB's deflationary policies. Today, the eurozone is experiencing zero growth and 12% unemployment. If there is a central bank which seems bent on distorting markets and lowering living standards, it is the ECB and not the Fed.

The only reason the U.S. dollar has held its relative value is its status as the reserve currency. This allows the Fed and Congress to get away with printing money and incurring massive debt that the market would not otherwise permit.

CM: The reason that the US has substantial debt capacity, and the reason that its currency serves as an international reserve asset, is due to the country's long track record with respect to both creditworthiness and price stability. By contrast, while the euro was intended to compete with the dollar as a reserve currency, it has failed due to concerns about its liquidity and viability.

Unfortunately, having the world's reserve currency creates a huge temptation to overleverage and create an unsustainable level of debt. Someday the rest of the world may wake up and realize the United States is in poor financial condition — the emperor has no clothes.

CM: It is true that a country's debt capacity may exceed what would be an economically optimal level of national debt, as is clearly the case in Italy and Japan. Going forward, the US authorities must act to control the country's debt ratio. This will require: (1) deficit limitation; and (2) economic growth. The Fed's current pro-growth policies help in both respects. Growth increases government revenue and thus reduces the fiscal deficit. Growth increases the denominator of the Debt/GDP ratio, thus helping to control indebtedness. Further, the Fed's QE activities have reduced the national debt by over $2 trillion (via monetization). QE has not added to the nation's debt; without it the national debt would be substantially higher. The greatest threat to the creditworthiness of the US would be the adoption of "sound money" policies such as are now being pursued in the eurozone.

Current Fed regulatory policy is also increasing the risk in the banking system. All large banks are being forced to use the same regulatory-driven mathematical risk management

models. This means that all the major banks will have a strong incentive to take the same type of risk, which significantly increases the overall risk in the financial system.

CM: The purpose of the Fed's bank "mathematical risk management models" is to reduce the risks taken by large banks. I am unaware of a better capital adequacy approach offered by Cato or anyone else. Certainly the alternative to regulatory-driven models, which is proprietary risk models, has been proven to be inadequate (see: 2008).

The significant expansion of the monetary base (printing money) is surely creating misinvestments in the economy. The combination of easy money, low long-term interest rates, and very liberal lending standards by the Federal Housing Administration could be igniting another housing bubble, while we are still trying to recover from the last one. These combined government policies are encouraging consumption (housing is consumption) when the U.S. economy has a negative real savings rate, when government deficits (including unfunded liabilities) are considered. The lack of real savings and capital will reduce our longterm ability to grow the economy.

CM: The expansion of the monetary base has only produced modest growth in the money supply. The Fed's post-Crash policy has been designed to encourage the return of economic activity in the household and business sectors. As a result of the Crash, housing starts declined from 1 million units to 500 thousand units. The recovery to pre-Crash activity levels has taken five years. House prices and housing affordability levels are more healthy than in 2007, with no evidence of another bubble.

By holding interest rates below what the market would create, the Fed is punishing moderate-income savers, especially older individuals. Retired individuals with low to moderate net worth should not be making risky investments. However, the Fed has forced down interest rates so that low-risk investments have negative real returns. This means that many older individuals who hoped to live on their interest income are having to consume their principle [sic], which threatens their standard of living. On the other hand the extra liquidity created by the Fed is driving higher returns in risky investments, typically owned by high-net-worth individuals.

CM: The principal beneficiaries of the Fed's pro-growth policies are the unemployed and young people entering the job market. The alternative, as we see in Europe is high unemployment and very high youth unemployment.

The primary beneficiary of the Fed's low interest rate strategy is the U.S. government, the world's largest debtor. The federal government's annual deficit is at least $250 billion less than it would be if interest rates were normalized. It appears that the real purpose of the Fed is to obtain favorable financing for the U.S. government, at the expense of private savers.

CM: The primary beneficiaries of the Fed's low interest strategy are those households which depend upon employment to maintain their standard of living. A secondary beneficiary is the taxpayer of today and tomorrow, who would otherwise have been burdened with a substantially higher national debt had nominal growth been lower than it was. While some private savers who made the decision to keep their savings in short-dated instruments have suffered, those who kept their savings in bonds, annuities or stocks have done well.

The good news is that the United States is experiencing an economic recovery. However, it is the slowest recovery in our history, and we still have three million fewer jobs than in 2007. If markets had been allowed to correct, if the Fed had maintained sound money, and if fiscal and regulatory policies were rational, our growth rate would be significantly faster and the U.S. government's financial position much sounder. At Cato we are working hard to encourage less regulation, lower taxes, less debt, and sound money.

CM: If markets had been allowed to correct, quite a few of the big banks would have failed in October 2008 and would have defaulted on their liabilities including uninsured depsosits. This would have prompted a sharp decline in the money supply, nominal GDP and employment, as was experienced during the Hoover administration when such an experiment was first attempted. I wish that Cato would stick to advocating less regulation, lower taxes and less debt, and would leave "sound money" to those who understand what that incantation really means.