The Coming Fiat Money Cataclysm and the Case for Gold

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> An almost hysterical antagonism toward the gold standard is one issue which unites statists 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

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own ends. This conflict is perhaps most clearly seen in the early 20th 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 represented by the German legal scholar Georg Friedrich Knapp and by 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 18th 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 overissue 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 percent of its purchasing power.[1] 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

[1]Using official BLS CPI data. By the same measure, which actually understates the problem, the dollar has lost 94.2 percent of its purchasing power since Roosevelt effectively ended the gold standard in 1934.

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 a collapse of their fiat money regimes.[2]

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. Hayek 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 which earlier malinvestments are abandoned and the economy goes through the necessary but inevitable painful restructuring (see also O'Driscoll 2011).

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 keep 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 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

[2]For more on the coming fiat money collapse theme, see Shelton (1994), Lewis (2007), Schlichter (2011), and Williams (2011).

more markets (financials, general stocks, Treasuries, junk bonds, and commodities) 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 legions 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. 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 United States 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 during 2005–09 annual average multifactor productivity grew by only 0.2 percent, well below the post-1948 average of 1.17 percent. Had multifactor productivity in 2005–09 risen at its long-term rate, output in 2009 would have been perhaps 5 percent higher.

Taking these effects together, we can see that lower interest rates have damaging effects on capital accumulation, output, and living standards. 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 (5) reduced savings rates which discourage the accumulation of capital in the first place (see Dowd and Hutchinson 2011).

State Intervention and the Financial System

State intervention also has a profoundly damaging effect on the financial system. Government deposit insurance, for example, creates a well-known moral hazard that encourages banks to take more risks than they would otherwise take and increase their leverage, which 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” (TBTF).

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 (Dowd et al. 2011, Kerr 2011b). 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[3] 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 percent to about 15 percent.

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

- 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 generated 74 percent of their pretax income from trading (Wilmers 2011) and yield-curve riding courtesy of the Fed.[4]

[3]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 a special purpose vehicle or SPV that issues two tranches of notes, where the junior piece is sized sufficient to procure a triple-A rating for the senior tranche, 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.

[4]The Fed's interest rate policy allows banks to borrow short-term at close to zero and invest at around 3 percent 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 percent spreads leveraged 15 times or so to make a comfortable 45 percent or more return. Becoming a yield curve player is far more profitable and avoids all that tiresome bother and risk of lending to small businesses.

- Bankers are overcompensated. To illustrate: the average investment banking compensation at four of the top banks was at least six times that of the 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 (Wilmers 2011).
- The banks enjoy unique privileges (lender of last resort support, massive bailouts, and TBTF) all underwritten by the state, and are hopelessly dependent on the continuation of current low interest rates policies.
- Confidence in the banks has long since evaporated; unsecured interbank lending has all but vanished; and the banks are kept going only 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 (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 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 underestimate correlations).
- Financial engineering (e.g., collateralized debt obligations or CDOs, in which claims against underlying pools of loans or bonds are tranched or ranked by seniority and sold off), and derivatives (especially credit derivatives, e.g., credit default swaps or CDSs, or bets on credit events such as downgrades and defaults) designed to slice and dice risks to maximum personal advantage. Particularly helpful in this regard are

synthetic positions (e.g., synthetic CDOs that are even more highly leveraged and in which little or no cash changes hands up front). These include CDOs-squared (i.e., CDOs in which the underlying pools of loans or bonds are replaced with CDOs) and even CDOs-cubed (in which the underlying pools are replaced with CDOs-squared). A remarkable example of the economically most destructive engineering was the synthetic CDOs designed to keep the subprime 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 (Lewis 2010).[5] This explains why the eventual subprime losses suffered by the banking system were substantially greater than the volume of the subprime market itself.

- Accounting and regulatory capital 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

[5]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 percent rated as AAA risk. The way to understand this is to look at the cash flows 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 cash flows were then assigned to a new SPV that issued the same fixed amount of synthetic subprime CDO whereby the cash flows from the fund mirrored the cash flows from actual subprime 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 the loans defaulted.

models to assign AAA ratings and hence give apparent respectability to dubious financial structures and, of course, highly gameable Basel regulatory capital rules.

The resulting "dark side" financing then enables bankers to (1) 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); (2) 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); (3) transform expectations of future profits, however unrealistic, into current recorded profits; (4) run rings around the regulatory system without the latter noticing; (5) bribe shareholders with high dividends, not to mention buy off politicians, and run off with the rest of the proceeds—that is, extract the maximum possible rents not only from the financial system but, 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 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 interbank 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.[6] The deal is classified as a repo (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.[7] 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 while 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

[6]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.

[7]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.

was a notable feature of the Troubled Asset Relief Program (TARP)—recycling their worst assets into securities that can then be sold or repo'd to the local central bank and manipulating "quantitative easing" (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 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 TBTF bank from which he can expect to earn an extraordinary and almost guaranteed coupon return of 15 percent in an almost zero interest rate environment, confident in the knowledge that his investment is underwritten by the prospect of a future government bailout (see Kerr 2011a). If this is good news, then the United States is in a truly dire state.

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. 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) to address the underlying causes, combined with major fiscal retrenchment to put public finances in order. These actions would have restored sound governance structures and reigned in excess risk-taking.

Instead, the actual policy response was much the opposite: the authorities did everything possible to stimulate the economy and put off any unpleasant restructuring. The Fed funds interest rate was pushed down from 5.26 percent 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 until at least mid-2013.

At the same time, the Fed engaged in massive purchases of bank assets financed by printing money (with the monetary base growing from around $800 billion before the crisis to nearly $2.7 trillion, an unprecedented rise of about 330 percent) and assorted other support to the financial system (e.g., TBTF bailouts, and *qualitative* easing), while 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 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 the 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. 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 around: the Fed seems unable to learn from its own repeated mistakes.

- 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.
- 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.
- 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[8] 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 its balance sheet and Dodd-Frank). Commenting on the discussions that surrounded the reforms of the early 1980s, Richard Timberlake (1985: 101) observed:

> 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.

"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 the conclusions Timberlake (1986: 759) reached 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.

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

[8]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 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).

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 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 percent of all that is written about it (Tullock 1975: 39–40).
- It distorts monetary research: a recent study by Lawrence H. White (2007) 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.[9] 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 (Dowd 1993) 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

[9]White (2007: 331) cites the case of one academic, whose criticism of a policy decision 50 years earlier was censored.

> 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,[10] and macro-prudential regulation.[11]

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.

Such hegemonic institutions have no place in a free society or a free market. Many of the Founding Fathers understood this too. That is why the Constitution did not give the federal government authority to charter a national bank.

The Fiscal Context

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 percent of GDP before the crisis to over 10 percent now, with the deficit itself currently running at $1.3 trillion a year; and

[10]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's preferred "first best" solution was no lender of last resort at all.

[11]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. 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 regulation.

government official gross debt levels rose from 64 percent of GDP to over 93 percent. Such spending is unprecedented in a period in which the United States is not engaged in a civil or world war. Even in the 1930s, the federal deficit only peaked at 5 percent of GDP and government debt in 1940 was only about 50 percent 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.[12] 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 percent from its low point in May 2007 to about 20 percent now, and real GDP is still below its 2007 levels. Or to put it another way, the biggest stimulus in history failed to stimulate.

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 (Kotlikoff 2011). 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.

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 kept going only because it is being propped up by the

[12]S&P downgraded the federal government's credit rating from AAA to AA+ in August 2011. Dagong, the Chinese rating agency, downgraded the U.S. government's credit rating twice last year and now gives it a rating of single A.

government, and the government is itself insolvent.[13] Thus, the whole system is insolvent and no insolvent system can last indefinitely. Collapse of the system is inevitable.

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 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,[14] 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 nonfinancial firms, the Fed, and the government are all now addicted to cheap money and unable to function without it.

[13]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 percent. Were the Fed a regular commercial bank it would be regarded as insolvent under Basel capital rules. Most of its assets are government bonds, and elementary analysis shows that if interest rates rise by even a smidgeon the value of the Fed's bonds will fall by more than 2.5 percent (i.e., the Fed will be revealed to be insolvent). To illustrate, assume 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 percent rise in interest rates to wipe out the Fed's capital. To make matters even worse, 36 percent of the Fed's assets are not regular bonds at all, but mortgage-backed securities and similar toxic assets purchased to bail out the rest of the banking system. Many of these assets are 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 also kept afloat by government guarantees. Consequently, the Fed is *already* insolvent, even using data based on its own privileged and unaccountable accounting practices.

[14]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 percent rise in interest rates would inflict a hit of $1.6 trillion on bondholders. 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.

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 United States 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. By this point, real interest rates are in deep negative territory and set to go south, and the public are visibly losing confidence in inconvertible paper currency.

The next, critical, stage along this path was passed 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 refuse to lend 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 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. They will then stampede for the exits.

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. 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 overexpanded) monetary base of over $2.7 trillion to, say, $17 trillion, an expansion of over 600 percent.

Inflation would then rise very sharply and remaining confidence in the dollar would soon collapse.[15] Foreign holders of both U.S. dollars and dollar-denominated assets would dump them fast; the huge overseas holdings of dollars (about $12 trillion) 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

[15]A possible counterargument is that a rapid rise in inflation could be avoided by the Fed sterilizing the increase in base money. However, the Fed would have to sterilize almost all the extra base money, and it is difficult to envisage how it might practically do so. It is also difficult to imagine how such a large increase in the base, sterilized or not, could produce anything but a collapse in remaining confidence in the dollar.

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 infrastructure—the payments system, the provision of credit, the financial system itself—would disintegrate, and of course the economy would collapse.

This outcome can be avoided by only 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 (see Schlichter 2011: 234–35).

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

A New Monetary System

Restore the Gold Standard and End the Fed

A gold standard would impose a much needed discipline on the issue of currency and on attempts to manipulate interest rates. A gold standard is not without its flaws, but is vastly better than the unmanageable fiat system that replaced it. The gold standard has a very creditable historical track record in delivering longer-term price stability, and the ultimate endorsement, to our way of thinking, is 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 much exaggerated—that is, the deflation "problem" is largely a bugaboo fed by misinterpretations of the 1930s and the earlier 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 it benefits, leading 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 International Monetary Fund 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 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 19th 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, but may be inevitable anyway. Indeed, there are numerous indications that a gold standard is already spontaneously re-emerging. Banks such as Austria's Raiffesen Zentralbank now offer clients gold-based accounts and others are offering gold ATM machines. 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. The next stage would be gold invoicing, 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 United States, Utah has already passed a law to repeal its capital gains tax on gold and silver coins, which 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. In Switzerland, there are moves to establish a gold Swiss franc and allow free gold coinage. Within the Islamic world, Indonesia has already reestablished a gold dinar, and in Malaysia, the states of Kelantan and Perak have reestablished both the gold dinar and the silver dirhem. And in Zimbabwe, still smarting from its experience of hyperinflation, the central bank has recently proposed a gold-backed Zim dollar.

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 decisionmakers. 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 Securities and Exchange Commission. These reforms would establish a free market in financial services and incentivize financial institutions to maintain their own financial health, which 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 United States needs reliable accounting standards that are principles-based, not the current plethora of thousands of pages of rules of current U.S. GAAP. The new standards need to ensure that any

reported profits are true realized profits, not fake profits generated by highly gameable mark-to-model valuations disconnected from market prices. A good role model here would be UK GAAP before the UK unwisely adopted IFRS accounting standards in 2006.

A New Constitutional Settlement

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 be achieved only by a "free money" constitutional amendment. To quote Henry Holzer (1981: 202), 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*.

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.[16] We should heed Thomas Jefferson's advice, "To preserve our independence, we must not let our rulers load us with perpetual debt."

[16]The dangers and indeed unsustainability of deficit finance were pointed out long ago in a classic study by Buchanan, Wagner, and Burton (1978).

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.

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