

**THE PRICE OF MONEY: CONSEQUENCES
OF THE FEDERAL RESERVE'S ZERO
INTEREST RATE POLICY**

HEARING
BEFORE THE
SUBCOMMITTEE ON
DOMESTIC MONETARY POLICY
AND TECHNOLOGY
OF THE
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U.S. HOUSE OF REPRESENTATIVES
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THE PRICE OF MONEY: CONSEQUENCES OF THE FEDERAL RESERVE'S ZERO INTEREST RATE POLICY

Friday, September 21, 2012

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC MONETARY
POLICY AND TECHNOLOGY,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:33 a.m., in room 2128, Rayburn House Office Building, Hon. Ron Paul [chairman of the subcommittee] presiding.

Members present: Representatives Paul, Jones, Lucas, Luetkemeyer, Huizenga, and Schweikert.

Chairman PAUL. This hearing will come to order. And without objection, all Members' opening statements will be made a part of the record.

I want to welcome our two witnesses here today, and I will now recognize myself for 5 minutes to make an opening statement.

Today, we are emphasizing the importance of interest rates. In a free market, interest rates are crucial. It is a crucial bit of information that tells a lot of people what to do, whether it is the investors, the savers, the spenders, consumers, whatever.

But once it is interfered with and interest rates are artificial, it tends to mess things up.

We talk a lot about monetary policy and the soundness of the dollar and the spending and monetizing of debt. Today, we are more or less concentrating on that aspect of monetary policy that deals with interest rates—how important is it—and has that whole emphasis on interest rates and this concession through the Federal Reserve (the Fed) that they have a duty and sometimes an unregulated duty to pretend they know what the interest rates should be.

This opens up a lot of questions. Who benefits and who suffers from this? Has it done any good? Is it a worthy effort even to try to pretend that we know what interest rates should be? And figure out exactly how much difficulty it has caused.

From my viewpoint, I think that, from the viewpoint of the marketplace—just as all prices, I want the market to set these prices. And we have been living now with a Federal Reserve for 100 years, and early on, they were manipulating interest rates.

It is hard to manipulate the supply of money or be the lender of last resort without getting involved in interest rates. And it is usu-

ally done with either trying to prevent a problem or to solve a problem.

But if we look at history, especially in our last 100 years, we have had a lot of ups and downs. It hasn't been smooth sailing. The Federal Reserve is supposed to be providing for a sound dollar and making sure that prices are stable and that there is high employment.

And yet the results that we see today, because they have pursued this almost obsession on believing that they can leap over into a central economic planning through the manipulation of money and credit, and in particular interest rates, we have ended up with some pretty poor results.

So I am working under the assumption that we are in a period of time probably unparalleled in our history, possibly unparalleled in the history of the world, because we have never had quite the global economy involved like we have today and we have never had a single fiat currency for 30, 40 years being used as the reserve currency of the world. So I think the distortions now are so great.

And if it is indeed true that the concentration on interest rates might be the culprit, it would be good to get it exposed, so that when the time comes when it becomes an absolute necessity to try to correct this problem, we might be able to put a better system together.

So I am delighted today that we have been able to bring two individuals who are very well-versed on this subject to talk about this, and other members of the committee, to emphasize the importance of price fixing of money.

Some people don't like to call it price fixing and they refer to it as something in interest. But in a way, it is easy to understand it is a price fixing.

Price fixing is bad when we have wage and price controls. Not many people are advocating wage and price controls at the moment, even though there is a lot of that going on in a subtle way, if money is one-half, the currency is one-half of every transaction and you have some price fixing involved in the price of money, it can be a fairly significant event that should be exposed, and we certainly ought to recognize that as we move into that period of time when there is a necessity for monetary reform.

So I am delighted that we have had this opportunity to further this discussion.

I would now like to yield 5 minutes to the gentleman from North Carolina, Walter Jones.

Mr. JONES. Mr. Chairman, thank you. And I won't take but 1 or 2 minutes. I want to thank you again for your national leadership on this area of monetary policy and concerns of where this country is going.

And to our witnesses today, thank you very much. I look forward to listening to your comments.

I don't think there is a better time, when we are going home for the next 5 weeks, all of us in the United States Congress, to be with the people. And knowing that I am from eastern North Carolina and the concern about the actions of the Federal Reserve, I think the topic today is absolutely fascinating and critical.

So I just want to say to you, Mr. Chairman, thank you very much for holding this hearing, and I look forward to listening to the witnesses and thank them for being here. And just thank you for your service to our Nation.

I yield back.

Chairman PAUL. I thank the gentleman.

I now yield time to Mr. Lucas from Oklahoma.

Mr. LUCAS. Thank you, Mr. Chairman. And as all of the hearings that you have called in your tenure as a subcommittee chairman reflect, this is an important subject matter and something on which we all need to focus. Perhaps not quite as exciting to the membership, as one can tell, as it should be, but nonetheless it cuts to the very basis of how our free market system works in this country.

That said, let me reminisce for just a moment, since this session of Congress is beginning to wind down, and there is always a possibility this might be the last hearing of this subcommittee. I suspect we might be around after Election Day, but a lame duck session is to be avoided if it is humanly possible.

I would just simply note that—having sat next to you on this dais on the full committee and served on your subcommittee for almost a decade now—we have had many a good policy discussion, and not just monetary policy, but we have discussed the intricacies of farm policy, agricultural economics.

It might surprise some of you to know that Dr. Paul and I, while we agree on many, many, many things, we are not exactly in sync on agricultural economics. But we have had some lovely, very thoughtful, to-the-point discussions, and you have opened my mind in an area or two, and I appreciate that. And I hope perhaps even on an occasion or two, I have offered a thought for you to think about. But you have just been a pleasure.

And if Congress is about free elections, and an open and thoughtful debate process where policies can be formulated in the best interest of the country, then I think you have done more than your part, and we will all be ever so appreciative of that for many, many years to come.

And with that, thank you, Mr. Chairman.

Chairman PAUL. I thank the gentleman.

And now, I yield time to Mr. Luetkemeyer from Missouri.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. I add my congratulations and empathies from Chairman Lucas as well. It has been an honor to serve with you these past 2 years.

The subject we have today I think is extremely important from the standpoint that the Fed continues to tinker around with our economy through the money supply, and, from all things that I see, it is having minimal success. I am concerned about the direction that they are going, the situation that they are putting us in.

If you look at the global situation, other entities, central banks around the world, they are struggling. And is this the proper path to take? I don't know, I am not an economist, and I think there is a general disagreement even with good economists on whether it is a good policy or a bad policy.

But I think that the discussion is pertinent, extremely important to today's economic welfare from the standpoint that we are in an

economic stagnation period here, and how we get out of this is everybody's concern.

And I think monetary policy by the Fed and their money-supply policy is an extremely important subject to discuss.

So with that, I thank you for the subject today, Mr. Chairman, and I yield back.

Chairman PAUL. I thank the gentleman.

Now, I yield time to Mr. Schweikert from Arizona.

Mr. SCHWEIKERT. Thank you, Mr. Chairman. I will be very quick.

You do realize that you letting me on this subcommittee has really screwed up my subjects of reading over the last 2 years. All of a sudden, I find myself reading more about monetary policy than I ever thought I would want to touch. And I have learned a lot. I have also worked through a series of things that I realize are just sort of complete folklore out there.

And, Mr. Chairman, I am hoping also in our testimony and in some of the discussion, I am one of those who is absolutely fixated on the concept that interest rates ultimately are the pricing of risk and where interest rates and capital flows, and then that interest rate charged to where that capital flowed is sort of an allocation and a management of risk.

Do you end up moving large amounts of capital, or even sometimes, us as individuals, capital to places that it shouldn't be because it is misallocated and mispriced? And what are the ultimate consequences for what we have done here when we have basically destroyed what should have been the historical pricing mechanism or risk mitigation, risk analysis system, which is interest rates and our economy.

And with that, Mr. Chairman, I look forward to the testimony.

Chairman PAUL. I thank the gentleman.

We will now proceed to our witnesses.

First, Mr. James Grant is a noted investor and founder and editor of Grant's Interest Rate Observer, a widely circulated bi-monthly newsletter on finance that accurately foresaw the financial crisis.

A former columnist from Barron's, he is the author of five books on finance and financial history. Mr. Grant has appeared on television programs such as "60 Minutes" and "The Charlie Rose Show" to share his expert knowledge of finance, and his journalism has been featured in numerous publications, including The Wall Street Journal, the Financial Times, and Foreign Affairs.

Second, Mr. Lewis Lehrman is a senior partner of the investment firm L.E. Lehrman & Co., and is chairman of the Lehrman Institute, a public policy organization he founded in 1972, where he heads up the Gold Standard Now Project.

As a member of President Ronald Reagan's Gold Commission, Mr. Lehrman helped write the Commission's minority report entitled, "The Case for Gold."

Over the years, he has written widely about economic and monetary policies and has been featured in Harper's, The Washington Post, and The New York Times, among others.

Without objection, your written statements will be made a part of the record. You will each now be recognized for a 5-minute summary of your testimony.

Mr. Grant?

STATEMENT OF JAMES GRANT, EDITOR, GRANT'S INTEREST RATE OBSERVER

Mr. GRANT. Mr. Chairman, and members of the subcommittee, good morning. It is an honor and a pleasure, and may I underscore honor to be here.

The price mechanism is our indispensable contrivance, and without it, the store shelves would be stocked with things we don't want, if they would be stocked at all. Our economy is wondrously complex, and what coordinates the moving parts is Adam Smith's invisible hand.

For a superb critique of the perils of price control, look no further than Ben Bernanke's own lectures last March to the students of George Washington University. "As you know," the chairman reminded his charges, "prices are the thermostat of an economy; they are the mechanism by which an economy functions. So putting controls on wages and prices," here Mr. Bernanke was referring to the disastrous Nixon experiment of the early 1970s, "meant that there were all kinds of shortages and other problems throughout the economy."

Yet this same observant critic is today leading the Fed in a policy of financial price control, to call the thing by its name. Interest rates are, after all, prices. They convey information, or are intended to. Market-determined interest rates are the prices that balance the supply of savings with the demand for savings.

These, however, are not our interest rates. Actually, we hardly have any. They are so small you can hardly see them. They are tiny. Today, the Federal Reserve imposes interest rates, and those rates it does not impose, it heavily influences.

Mr. Bernanke's bank fixes at zero percent the basic money market interest rates called the Federal funds rate that manipulates the alignment of rates over time, the yield curve, and it has its fingerprints all over the relationship between government yields on the one hand, and the yields attached to private claims on the other.

The Federal Reserve has decreed that ultra-low interest rates are a necessary if not sufficient condition for economic recovery. It says that miniature interest rates will boost hiring and another aspiration of the central bank, keep consumer prices rising by just enough; "a decent minimum, say, of 2 percent a year," so says the Fed.

Now, every market intervention has consequences, but not necessarily the consequences that the intervening authority intended. In the nature of things, there can be no predicting exactly what will come of today's radical and indeed unprecedented monetary policies.

Mr. Bernanke himself makes no bones about it in his widely scrutinized speech at Jackson Hole, Wyoming, on August 31st. He used the phrase, "learning by doing." Indubitably the Fed is doing, nobody can doubt its manic energies, but it seems not to be learning.

Artificially low interest rates must inevitably subsidize speculation at the expense of saving. It must raise up the prices of stocks

and commodities, but only temporarily. It must enrich the asset holders and inadvertently punish the wage earner. It must advantage one class of financial institutions—say, banks—over another—say, life insurance companies. It must disturb the currency markets, and therefore interfere with international trade, and it must conflate our understanding of the strength of the Treasury's own finances.

This year, in the just-ending fiscal year—or the soon to end—the interest cost in the debt will run to an estimated \$125 billion. That happens to be slightly lower than the outlay the Treasury bore in 2006 when the debt was 58 percent smaller than it is today, but when the average interest rate was a towering 4.8 percent as opposed to the current average of 2.1 percent.

Ultra-low rates flatter the Nation's credit profile, yet that credit profile remains the same.

Mr. Chairman, millions of Americans are earning nothing on their savings. Having nowhere else to turn, they are investing in richly priced corporate debt, some of that speculative grade. The Fed author of this interest-rate famine of ours has inadvertently created a paradox that would be funny if it weren't dangerous.

Mr. Bernanke's bank has created a high-yield bond market, junk bonds to the cognoscenti, but a market lacking one customary attribute of high-yield security. That is, the Fed has created a high-yield bond market without the yield.

I thank you.

[The prepared statement of Mr. Grant can be found on page 22 of the appendix.]

Chairman PAUL. Mr. Lehrman, go ahead.

STATEMENT OF LEWIS E. LEHRMAN, CHAIRMAN, THE LEHRMAN INSTITUTE

Mr. LEHRMAN. So, Mr. Grant and I like to switch one sentence to express how much we honor the extraordinary record of the chairman in his 30 years plus, perhaps, service in the Congress. It has been a heroic effort on behalf of the authentic Constitution, and on behalf of the liberties which we have inherited from our forefathers, and of course, for sound money.

Now, Mr. Grant is about six feet, five inches tall. I am only five feet, 10 inches tall, and he determined the protocol of our presentation. So, he established that he would focus on the problem, and I should spend a moment or two on the solution.

Indeed, Jim has described the consequences of Federal Reserve quantitative easing and interest rate manipulation and suppression.

From Mr. Grant's analysis, one concludes that the Fed's unlimited power to purchase Treasury debt and financial market securities not only funds the Treasury deficit with newly printed money, but the Fed's market intervention process also makes of the financial class a special interest group of privileged investors and speculators, because of their special access to subsidized funds at near zero interest rates, while middle-income families depend upon their credit card balances and pay upwards of 20 percent or more.

A well-connected financial class subsidized by the Federal Reserve is a crucial cause of increasing inequality of wealth in Amer-

ica. In this regard, I would cite only one fact for the Monetary Policy Subcommittee to contemplate. Since the termination of dollar convertibility to gold in 1971, a mere generation, the financial sector has doubled in size as a share of the American economy, but the manufacturing sector has been cut in half.

Only comprehensive reform of the Fed and termination of the Reserve currency role of the dollar will arrest this trend. For example in 2002, Mr. Bernanke described the Fed's extraordinary power to create new money and credit in our present financial regime of inconvertible paper money and inconvertible bank deposit money.

I quote Mr. Bernanke, "Under a fiat paper-money system, a government, the central bank in cooperation with other agencies, should always be able to generate increased nominal spending and inflation. Even when the short-term nominal interest rate is at zero, the U.S. Government has a technology," Bernanke continues, "called a printing press, or today its electronic equivalent that allows it to produce as many U.S. dollars as it wishes at essentially no cost."

Reading this, I don't know whether to laugh or to cry. In effect, as James Grant wrote elsewhere, "The Fed is not only the American central bank, but with this exalted power to print money, the Fed is now the government's central planner."

During the Volcker years, from 1979 to 1987, Fed interest rate manipulation was justified as the means to end inflation. By 1994, employment as a Fed target had all but disappeared from the minutes of Fed meetings.

Now, in 2012, despite inflation being again on the rise, employment is as a practical matter the sole target of quantitative easing. The Fed and its apologists in the media and the academy justify quantitative easing and its unlimited scope and duration as the way to restore economic growth—surely, an extra-Constitutional form of fiscal spending through Federal Reserve capital allocation reserved for the Congress of the United States.

But as soon as one examines that Federal Reserve balance sheet, which if I may say so, few politicians do, one sees that the Fed primarily buys Treasury securities and mortgage-backed securities. In effect, a subsidy by which to finance the government deficit, and to refinance bank balance sheets that is to say the promotion of more financial and consumption sector growth. In a word, quantitative easing is the most pernicious form of trickle-down economics.

Now, the problem of the American economy is neither under-consumption nor is it under-banking. The problem is the lack of rapidly growing investment in domestic production and manufacturing.

The investment is the necessary means by which to enable our producers to lead in both domestic and global markets. It is rapidly increasing investment and production growth which begets employment growth and with it healthy unsubsidized consumption growth, not by means of transfer payments.

It is a truth of economic theory and practice that rising personal and family real income grows from increasing per capita investment in innovative businesses; new plant, new equipment. So the question is, in reforming the Fed, how can our runaway central

bank be harnessed by the financial markets to target the goal of economic growth through increased productive investment, not the promotion of consumption and Treasury deficit financing by means of interest rate manipulation and quantitative easing?

The answer, I believe, is transparent. The Congress of the United States has the exclusive constitutional power under Article I, Sections 8 and 10, not only to establish the definition of the dollar, but Congress also has the power to define by statute the eligible collateral that the Federal Reserve may buy and hold against the issue of new money and credit.

Thus, a simple congressional statute defining sound commercial loans as the primary eligible collateral for discounts and new credit from the Fed would have two primary defects. First, it should rule out Fed purchases of Treasuries, thus requiring the government to finance its deficits not with newly printed Fed money, but instead in the open market away from the banks.

Second, the Fed would then become a growth-oriented central bank by which to finance productive business loans, encouraging thereby commercial banks themselves to make banks to solvent businesses in order to sustain economic and employment growth.

Now, why is this the case? Commercial banks would focus on production and commercial loans because solvent loans, instead of Treasury debt, could then be used by commercial banks as the primary eligible collateral by which to secure credit from the Fed as the lender of last resort. In a word, Treasury subsidies by the Fed should be displaced by productive business loans oriented toward economic and employment growth.

Mr. Chairman, this simple proposed reform of Fed operations was the very monetary policy insisted upon by Carter Glass, a leading Democrat who was the chief sponsor of the Federal Reserve Act of 1913. The congressional legislative leaders who created, indeed founded, the Federal Reserve System of 1913 designed the Fed by law to enable steady commercial investment and employment growth.

The Federal Reserve Act was also designed explicitly to uphold and maintain dollar convertible to gold in order to maintain a reasonably stable general price level. Now, such a congressional Federal Reserve reform today, consistent with the original Federal Reserve Act, would require no further legislative mandate to sustain employment growth and to rule out systemic inflation and deflation.

Just a word more—so today, the Fed reiterates at every meeting that it, the central bank, must manage and manipulate interest rates to fulfill a congressional mandate to maintain reasonable price stability and reasonably full employment. But the best way to do this is to remobilize the express intent and the techniques of the original Federal Reserve Act, namely the statutory requirement that the Fed uphold the classical gold standard and, as was intended by the original Federal Reserve Act, to substitute commercial market credit for Treasury debt as the primary eligible collateral for bank loans from the lender of last resort, the Federal Reserve System.

Mr. Chairman, may I say with respect, Congress has defaulted to the Federal Reserve System its sole and solemn constitutional

authority to define and to regulate the value of the dollar and to define the vital economic use of eligible collateral by which to obtain productive business loans from the Federal Reserve System. It does not have to be this way.

Thank you very much.

[The prepared statement of Mr. Lehrman can be found on page 27 of the appendix.]

Chairman PAUL. Thank you.

We will go into the questioning session right now. I yield myself 5 minutes.

I want to ask both of you the same question. In 1979, and the 1980s, we had a bit of a crisis, quite different than we have today because interest rates were very, very high and even made higher. At that time, as I recall, not too many people were happy and claiming they were getting benefits from the higher interest rates. I don't think the markets—the higher the rates went, I don't think the markets were saying “wonderful, wonderful.”

But today, even with this most recent announcement of the accelerated quantitative easing, there is almost an immediate response—as a matter of fact, instantaneous response. We are going to print a lot more money and those individuals who are holding stocks seem to be delighted with that and bonds rally.

My question is: Under today's circumstances, with this constant effort to keep lowering interest rates, now that they are down to essentially zero, below zero when you talk about real interest rates, who benefits from this? Who is really benefiting? And who are the people who are suffering? Can you divide it up and find out if there are some groups who have no benefit whatsoever and some people actually get punished? And other people are rewarded, whether it is temporary or not, at least they think they are being rewarded.

And if there is a case where somebody benefits, and somebody else is hurt, is this done on purpose? Or would you want to make a stab at it to say is this sort of a consequence of just bad policy? Or what might be the motivation here if there are winners and losers?

Mr. Grant?

Mr. GRANT. Mr. Chairman, the great French economist Frederic Bastiat talked about that which is seen and that which is not seen. There are many obvious beneficiaries. There are many obvious victims. Let me suggest a subtler distortion that these policies are responsible for, and then I will touch on some of the ones that are perhaps as important or more so.

Capitalism is a little like the forest floor. There is life. There is death. There is regeneration. There is movement. The famous phrase “creative destruction” defines the inevitable ebbing of economic power that was once constructive and now has passed its prime.

One of the consequences of these subsidized interest rates is that organizations that perhaps ought not to be around are given new life. The financial markets on Wall Street are increasingly welcoming to the most marginal credits because there is a stampede for interest income. People are starving for it and Wall Street is providing for it.

When nearly anyone can get a new loan—when nearly anyone can get a pass in the public market that means there are not enough bankruptcies. It is a problem, albeit a paradoxical one. We need new enterprise and we need the exit of unprofitable or over-the-sell-by date enterprise; so ultra-low interest rates perpetuate the status quo.

Interest rates, as someone mentioned, are among other things, great sources of information. When interest rates are pressed to the floor, the credit markets provide less and less information. The information is there, but it is not to be intuited by prices.

So, as to the other beneficiaries and losers, some of them are painfully obvious. The Fed talks more or less nonstop about inflation, but then I think is troubled by the lack of it. It wants to see more of it. Well, one department of American finance in which there is rampant inflation is the cost of obtaining a dollar of income. One might say the cost of retirement is in a terrific inflationary crisis.

A friend of mine and of Lew's, a Wall Street figure of wonderful renown and of some mordant future, said a while ago, before he passed away, "You know," he said, in all seriousness, "you really can't get by today without \$100 million."

The point survives the exaggeration. You need more and more capital to maintain a decent income as a saver. That, to me, is not the least of the cost of these policies.

Chairman Bernanke, in Jackson Hole, spoke to try to put our collective minds at ease about the unintended consequences of quantitative easing. And he said, "I can enumerate four possible pitfalls"—four. There are 400,000 possible pitfalls.

The Chairman, I think, is in error when he implicitly tells us that for every monetary cause A, there is a predictable monetary effect B. There are effect B, C, D, N, Z, and myriad effects that are so weird that no proper letter in the English language can describe them.

What we are now embarked on is one of the great monetary experiments of all times and, Mr. Chairman, we are the lab rats.

Chairman PAUL. Mr. Lehrman?

Mr. LEHRMAN. Mr. Chairman, you mentioned the period of 1979, 1980—that period of high interest rates over which Mr. Volcker presided. I was there and I remember it, just as you do. One of the remarkable things about a review of the history of the Federal Reserve System from 1914 until the present is that the techniques that have been used either to suppress interest rates or the use of vaulting interest rates to bring about changes in economic activity has seen no reform.

That is to say, Paul Volcker, you will remember in 1979, said his goal was to target the bank reserves; that is to say, to control the stock of money in circulation. This was another new experiment on interest rate manipulation, of course, with a noble intent.

But this was just another form of interest rate manipulation which ultimately wound up putting the prime rate at 21 percent and market rates for a long-term Treasury at the highest level that they would be in American history, approximately 15 percent.

It is forgotten in the dreamlike remembrance of that period that from 1979 to 1982 the American economy was in recession, the un-

employment rate in New York State in 1982 in November—I remember that date very well for personal reason—was 11.2 percent, higher even than the unemployment rate at the peak of the “Great Recession,” which we have undergone since 2008.

It was not a halcyon period. President Reagan’s first years of the Administration were almost impeached economically because of that.

So as the French say, the more it changes, the more it is the same way; that is to say, Federal Reserve interest rate manipulation and management for one purpose or another.

Who benefits and who suffers? In each period, under each of the Federal Reserve Chairmen who exercised this extraordinary power, it was different.

Today, I want to point out only in response to the question the technique and its effect by which the Federal Reserve actually does operate in open market operations at the New York Federal Reserve System and has done so since the First World War.

The Federal Reserve enters the market and purchases outright or on a match sale or on a repurchase agreement Treasury securities from the market against which they issue new money.

That new money is made available only to the banks because—or the today 16 authorized dealers. So their portfolios are reduced and substituted with new money, which they then are in a position either to lend out to dealers and brokers or speculators or Wall Street investors who can post collateral, liquid collateral, by which they then can satisfy the lend that they can repay the loan.

So the very first effect and the dominant effect, the generalized effect is commodity dealers and equity dealers who have first access to the money which is created anew by the purchase of Treasuries, which themselves cannot be repaid as they are refinanced with renewal bills.

This is a prescription and has been in effect for a very long time, but especially since the end of the Second World War and even more dynamically since the end of Bretton Woods in 1971, to enrich the investor class.

I cannot incriminate them because to a certain extent I am a member of that class, but one does not have to be a rocket scientist to see that the Federal Reserve’s process of monetizing the U.S. Treasury debt, providing new credit to the banking system to lend to their preferred clients divorces supply from demand, creating a monetary demand unassociated with the production of new goods and services.

When total monetary demand exceeds supply, which is the prescription and the technique of the Federal Reserve, inflation must get under way.

Now, that inflationary process today is hidden by the vast unemployed resources which we now have. And as a result, the new credit money immediately goes into the commodity and equity markets as well as into speculative vehicles like farmland, for example, which is the most exotic investment today of a sort of inside Wall Street investors.

No change can occur in such a process without a full reform of the Federal Reserve System and a reform of the monetary system.

Chairman PAUL. Thank you very much.

I now recognize Mr. Luetkemeyer for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

I appreciate your comments, Mr. Lehrman. They are interesting. You called farmland an “exotic” investment.

I am looking to try and buy the farm next to mine, and I wouldn’t think it would be an exotic investment. But I understand where you are coming from.

I am just kind of curious, if the Fed would not purchase all of the government’s debt, would there actually be a market out there, in your judgment, for our debt because of the size of the debt that we have, the amount of money that it would take to service that debt? Is there enough capital out there to service that debt? Is there enough capital out there to purchase that if we don’t run the printing presses here at the debt and pick it up, in your judgment?

Mr. LEHRMAN. May I first say, Congressman, that I am the owner of a 1,600-acre farm—corn, soybeans. And it is exotic from the standpoint of speculators who have never set foot in a cornfield, but certainly not from those—

Mr. LUETKEMEYER. That is who I am bidding against on the farm right now, are those guys.

Mr. LEHRMAN. So then you understand what—

Mr. LUETKEMEYER. Yes, I do.

Mr. LEHRMAN. —I was getting at.

Mr. LUETKEMEYER. But to me, it is not exotic. I would like to buy my neighboring farm, but to those folks, it brings the price up. I understand, but go ahead.

Mr. LEHRMAN. So the question is: What would happen if, as the founders of the Federal Reserve System intended, the Congress of the United States and the budget of the Treasury were not able to finance its deficit by selling securities ultimately to the Federal Reserve System? Is the open market substantial enough to accommodate the vast sums presently required by the Treasury in order to finance its current spending?

The answer to that is we would find that out, and it would be the ultimate discipline, which would require Congress on notice to the public that the financing of the Treasury was forcing interest rates higher and higher and excluding businesses and commercial firms from access to the credit markets because at the present level of deficits—let us call it all in about \$1.5 trillion, including the credit financing bank—it would absorb almost all the net national savings available in the market, which gets right to the point of this hearing. What is the effect of the suppression of interest rates and their manipulation and the financing of 77 percent of the Federal Reserve’s budget deficit in Fiscal Year 2011; what is the effect of that?

It disguises from the public, the sovereign people, the effects of the fact that only 60 percent of the revenues which Congress decides to spend are financed through taxes, and 40 percent of them through printed money either through the banks, the commercial banks, for foreign central banks.

Mr. LUETKEMEYER. I think there is another point to be made here too, which is the fact that because they are driving rates so low they are also disguising or hiding the fact—the exposure that we have when you go to \$16 trillion worth of debt in just—an addi-

tional \$4 trillion, \$5 trillion, \$6 trillion in the last 3 or 4 years—the amount of exposure we have to interest rate fluctuation. Right now, the cost of interest to our government is rather low compared to what it has been in the past because of driving interest rates down.

If that would not happen the rates would go back—it would be very easy to double or triple the rates, because they are so low right now. Imagine what it would do to our budget if you doubled or tripled our cost of funds.

Mr. LEHRMAN. We dealt with that issue at the last hearing, Congressman. We dealt with that issue. And were you to normalize the long-term interest rates—let us say for 30-year Treasury bonds—were you to normalize them consistent with the past history of the generation and given the scale of the direct debt of Treasury right now at \$16 trillion, the total amount of the Federal budget devoted to interest payments could rise to as high as \$800 billion, even towards a \$1 trillion if the deficit were to continue.

That puts, I think, a number on the effect.

Mr. LUETKEMEYER. Very good.

Very quickly, how do we unwind this? What happens when we unwind this thing?

Mr. Grant?

Mr. GRANT. We don't know. The Fed is—

Mr. LUETKEMEYER. We are still going to be a laboratory even for that.

Mr. GRANT. Yes. That, too, will be a learning-by-doing experience.

Mr. LUETKEMEYER. How painful will it be, do you think?

Mr. GRANT. Sorry?

Mr. LUETKEMEYER. How painful do you think it will be? Because—until interest rates rise, will inflation take place or will we go into a depression? Will it be runaway glory, everything going to be hunky-dory here? Or where are we going? If the Fed has to unwind this thing and get rid of the 2-point whatever—\$8 trillion now—

Mr. GRANT. Congressman, we can rule out hunky-dory.

As for the rest, we will see.

Imagine a day in which the Treasury, to finance another \$1.5 trillion deficit is raising, say, \$15 billion in 2-year notes in the morning; and in the afternoon the Fed is holding a special auction to liquidate the remaining excess portion of those balance sheets. So they will be one auction on top of another.

We simply don't know the outcome, but we do know, I think, that the Fed's assurances must be discounted. The Fed is remarkably complacent with regard to its capacity to form financial judgments. This is the outfit that panicked in front of the prices of computer clocks in 1999—neglected to see or to take due measure of the speculative mania in technology stocks that ended in the early aughts. And that positively saw not one aspect of the greatest credit crisis in three generations looming before it in the mid-2000s.

And we are meant to believe that the perspicacity of the judgment of the Fed will now help them anticipate the end of the necessity for this Q.E. and to unburden themselves of the excess security.

So I don't doubt that they mean to have the techniques to affect the exit. What I do doubt—and I think there is evidence in support of doubt—is that they have the judgment to mark the time and the need.

Mr. LEHRMAN. May I say a word on that question, Mr. Chairman?

Every Thursday, at about 4 p.m., the Federal Reserve System publishes its balance sheet. That balance sheet as of Thursday night, last night—I looked at it—shows that to do it in round numbers, the Fed owns approximately \$3 trillion of securities, primarily Treasury securities and mortgage securities, mortgage-backed securities and agency bonds.

If you look further into the detail and the footnotes you will observe that the largest fraction of the balance sheet of the Federal Reserve System is in long-term securities.

The historic practices of central banks during long periods of stable prices was only to own short-term securities so that were inflation to arise, they could, to use your phrase, unwind their portfolios selling securities, or letting them run off into the market in order to reduce the quantity of money and credit in circulation and stabilize the price level.

The Federal Reserve is now faced not only with the daunting task of unwinding the enormous monetization of Treasury and mortgage-backed securities, but they have encumbered the balance sheet with long-term securities which will not run off on a regular basis the way short-term commercial bills do with 90-day maturities.

They have the largest fraction of—far and away the dominant fraction in 10-to-30-year securities. So the only way they can get rid of them is to sell them into the open market.

If the economy is running full-tilt at full employment, and let us say the employment rate might be at 5 percent, it could have nothing less than, as you implied, a very dynamic effect on interest rates in general, not just in the United States, but worldwide in as much as the United States dollar is the world reserve currency.

Mr. LUETKEMEYER. Thank you.

I yield back. Thank you, Mr. Chairman.

Chairman PAUL. Thank you.

We are going to a second round now of questioning.

The first question I have I would like to get sort of a short answer for, because I have another question that follows and we will be voting on the Floor pretty soon. But what is your concept of the current situation now and whether or not we have a bubble? Most of us recognize a NASDAQ bubble. Others recognize the housing bubble. Do you see a bubble right now that could suddenly change and change the markets and all perceptions?

Mr. Grant?

Mr. GRANT. Yes, Mr. Chairman, I do. I see a bubble in Treasury securities. I see a bubble in sovereign debts worldwide. The world has come to believe that the promises to pay of sovereign governments are intrinsically safe—not everyone—but Northern European governments are meant to be intrinsically safe. Australia, I think there are seven or eight AAA-rated governments left on the

face of the Earth. People are crowding into the claims of these governments, not least into our own.

These are interest rates that have not been seen in modern times in Northern Europe. There are plenty of governments borrowing at negative interest rates. And as was the case in every single market bubble in history, there are wonderfully persuasive stories circulated to rationalize what on the face of it is an abuse of common sense.

So I nominate bonds themselves as our looming bubble.

Chairman PAUL. Mr. Lehrman, any additional comments?

Mr. LEHRMAN. The number of bubbles—even with vast unemployed resources in nations around the world, not just in the United States—is legion. And Jim has just mentioned some, but the Congressman and I were talking about farmland.

The value of farmland, as one vehicle for speculation, not only among well-positioned farmers, but I mean to say the investor class, the price of farmland, high-quality, let us say 160-bushel-per-acre, non-irrigated farmland from Central Pennsylvania all the way to the foothills of the Rockies, that is to say the great corn belt, has doubled just in the past 4 years.

This has never been experienced at quite this rate of change; or I should say this bubble has never occurred on this scale in the past. It is one more example.

Chairman PAUL. My follow-up question is to you, Mr. Lehrman. I would like Mr. Grant to comment as well. You talked about a long-term solution, more about the monetary reform and the use of gold. I want to concentrate more on that shorter-range solution or something you suggest that could help. And that is to look to the original Federal Reserve Act and not to allow the Fed to buy Treasury bills, but to allow the Fed to be the lender of last resort to sound commercial loans.

Did I state that correctly?

Mr. LEHRMAN. Exactly.

Chairman PAUL. Okay. If the Fed buys a commercial loan, they could buy this with money creation. Would this be expanding the money supply? Would this be monetizing a debt? And could it lead to a problem as well? Or would you argue that this is not monetary inflation?

Mr. LEHRMAN. I would argue it would not be monetary inflation. The difference is profound. The purchase of commercial bills for the purpose of production by the Federal Reserve or by commercial banks against the issue of new money goes to solvent firms who, in the process of production, then sell their output and they repay the loans.

And as a result, the new credit which has been advanced against the commercial bill or against the productive loan expands the money supply during that particular market interval. But 90 days later or 120 days later, the goods that were produced as a result of that financing realize their value and then those loans are liquidated, restoring equilibrium to the money market.

Chairman PAUL. So do you separate this from being the lender of last resort? Or would you put it in that category?

Mr. LEHRMAN. I use the phrase “lender of last resort” because that is, of course, the rationalization that everybody uses to give

the Fed the privileges to create money without limit. As the lender of last resort, the Fed would have the possibilities of buying solvent commercial loans in the open market, which themselves would be liquidated in a windup naturally in the course of economic activity.

Whereas, in the case of the Treasury, the Treasury is never able, under present circumstances, and has not been since pretty much the end of the Second World War, to liquidate the bills or the bonds which they are selling. And it leads to a permanent expansion of the money supply never to be unwound by the natural course of production.

Chairman PAUL. Would doing this interfere with interest rates?

Mr. LEHRMAN. In the case of commercial bills or productive loans, which the Fed would then discount when they were offered by the commercial banks against the desire for new credit, this would, in the same sense, lead to a rise in interest rates when credit demands were higher, and a fall in interest rates when the commercial loans were being repaid to the commercial banks, and the commercial banks repaying the central bank for the loans that they obtained against commercial lending collateral.

Chairman PAUL. Okay. And our voting has started, but I would like to get Mr. Grant to make a comment on that, if he could.

Mr. GRANT. I would vote. I am with Lew.

Chairman PAUL. Pardon me?

Mr. GRANT. I said I would go vote; I am with Lew on this. I can't add to this or shouldn't take your time in adding to it.

Chairman PAUL. Okay. Mr. Huizenga from Michigan, would you like to ask some questions?

Mr. HUIZENGA. I would. Also, Mr. Chairman, I want to say thank you for your service to our country and your time here in Congress, as well as your service to the philosophy, the battle that we have going on.

And the question I have is, I am curious if we can touch on the dual mandate of the Fed and what you believe that may have done to get us in the current situation. And would you suggest us changing that dual mandate of having them pursue low inflation and high employment? And any time I have, I would like to give back to the Chair if he so desires to do a follow up.

Mr. GRANT. Congressman, I think that one might, again, go back to the founding precepts of the Fed. The Fed got into business, if you read the opening paragraphs of the Federal Reserve Act, the Fed was to create a market in commercial bills and to exchange paper for gold in such a way as to support the working of the gold standard.

And the phrase added was, "and for other purposes"—pregnantly, it was added. But I would keep the mandate even simpler than one. I would say that the Fed ought to be in business to support an objective definition of the value of the dollar.

In this day and age, we could not have anything resembling industrial commerce as we know it without the most precise specifications of material weights and measures. And somehow, we have neglected this in money.

Money is what someone thinks it should be in some particular public institution like a central bank or a Treasury Department. The lead article of the Financial Times this morning was a plaint

by the finance minister of Brazil against quantitative easing on the grounds that the willful depreciation of the dollar—or I might say the willful redefinition of the dollar—would certainly lead to the interruption of trade and to frictions that did not exist previously.

The gentleman to my left has written a fabulous book on this, and I think it is his view as well that what is wanted is the restoration of objective value in the dollar. And if the Fed could do that and maintain it, it seems to me that good things would follow.

As it is, we have arrived at the most peculiar point in which people have come to think that if the Fed can raise up the value of stocks, bonds, farmland and commodities, somehow prosperity will follow. It seems to me that is a very peculiar horse in front of a very odd cart.

Mr. HUIZENGA. I appreciate that.

And Mr. Chairman, I am happy to yield my time to you.

Chairman PAUL. I thank you.

I will recognize Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Just very quickly, I only have a couple of questions.

Mr. Grant, what do you believe would be the ideal interest rate or the ideal range that the Fed should shoot for, that our rates should be for, say, our T-bills or Fed funds rates or home loans or somewhere in there? Use some of those figures.

Mr. GRANT. Sir, I think the Fed should not be shooting at those rates. I think that they should be determined in the marketplace. If you look back on history, kind of a normal mortgage rate was 4.5 to 5 percent; T-bill rate, maybe 3 to 4 percent; long-dated securities, yielding perhaps 6, 7 percent depending on the credit; and higher with regard to junk or speculative grade credits.

But I would let the wonderfully invisible forces of the marketplace into this line of work and let them do their thing—

Mr. LUETKEMEYER. Okay, if that is the case then, do you get rid of the Fed, or do you think there is a place for it?

Mr. GRANT. Sir?

Mr. LUETKEMEYER. Would you get rid of the Fed then or do you believe there is a place for it?

Mr. GRANT. I believe that the Fed ought to be doing much less than what it is doing, and it could do with many fewer economists. They could be doing with a much narrower mission statement and as long as we are talking about reforming this outfit, we should not fail to institute the Fed's first office of unintended consequences.

Mr. LUETKEMEYER. Mr. Lehrman, would you like to comment on that?

Do you believe we need to have a Fed or do you believe—

Mr. LEHRMAN. I have made the case in my book and in previous books that if we are going to have a Federal Reserve system—for it should be said it is not an indispensable necessity—but if we are going to have a mere agency of the Congress maybe with the stature, so to speak, of the Interstate Commerce Commission or the Federal Communication Commission, then it must be circumscribed by very careful rules, whereby it conducts its policy such that it is consistent with the activities of a free market and a free people.

So, that yes, I can embrace the Federal Reserve Act of 1913, and the very few moments in which it conducted itself according to Article I of the Constitution, Sections 8 and 10, namely, to define the value of the dollar, regulate the—

Mr. LUETKEMEYER. So you could live with it as long as it went back to its original intentions and functions?

Mr. LEHRMAN. I think we can go forward. We can't go backward, but I think we can go forward to a restoration of a Federal Reserve System which operates with some restraints imposed by Congress, the definition of the collateral, which is eligible at the Federal Reserve for discount against new money to encourage economic growth as opposed to encourage Treasury budget deficit.

Mr. LUETKEMEYER. Thank you.

Mr. Chairman, I yield back.

Chairman PAUL. Thank you.

I wanted to thank our Members who are here today, and our witnesses. And I appreciate very much you being here.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

This hearing is now adjourned.

[Whereupon, at 10:36 a.m., the hearing was adjourned.]

A P P E N D I X

September 21, 2012

United States House of Representatives
Committee on Financial Services
Subcommittee on Domestic Monetary Policy
Hearing on
"The Price of Money: Consequences of the Federal Reserve's Zero Interest Rate Policy"
September 21, 2012

Congressman Ron Paul
Statement for the Record

One of the most enduring myths in the United States is that this country has a free market, when in fact nothing could be further from the truth. In reality, government has pervaded so many aspects of the market that what we see as a free market is merely the structural shell of formerly free institutions, while government pulls the strings behind the scenes. No better illustration of this can be found than in the Federal Reserve's manipulation of interest rates.

The Fed has interfered with the proper functioning of interest rates for decades, but perhaps never as boldly as it has in the past few years through its policies of quantitative easing. In Chairman Bernanke's most recent press conference he stated that the Fed wishes not only to drive down rates on Treasury debt, but also rates on mortgages, corporate bonds, and other important interest rates. Markets greeted this statement enthusiastically, as they realize that this means trillions more newly-created dollars flowing directly to Wall Street.

What almost no one realizes, however, is that interest rates are a price, the price of money. Like any other price, interest rates perform both a signaling and a coordination function. Interest rates coordinate the actions of savers and borrowers: higher interest rates attract savers, lower interest rates attract borrowers, and the market interest rate provides an equilibrium between saving and borrowing. The interest rate also signals the availability of funds: lower interest rates signal an abundance of loanable funds, while high interest rates signal a paucity of funds. As interest rates rise, more people save and fewer people borrow; as interest rates fall, fewer people save and more people borrow. Lower interest rates also tend to favor longer-term, more capital-intensive projects. Projects which might not be profitable at eight percent interest rate may suddenly become profitable if the interest rate drops to three percent.

In order to lower the interest rate, more loanable funds must be available. But if individual saving habits remain unchanged, the only way to lower interest rates is to inject additional money or credit into the financial system. This new injection of credit, which has its origins not in savings but merely through a new bank balance sheet entry, results in a lowering of the rate of interest. The lower rate of interest signals the availability of additional loanable funds, which spurs additional borrowing. These borrowed funds are then put to use to fund capital projects. Additionally, as the interest rate lowers some savers may judge that their funds are now better off being used to fund present consumption, rather than continuing to be saved for future consumption.

Because the interest rate is the price of money, manipulation of interest rates has the same effect in the market for loanable funds as price controls have in markets for goods and services. Since demand for funds has increased, but the supply is not being increased by the market, the only way to match the shortfall is to continue to create new credit. But this process cannot continue indefinitely. At some point the capital projects funded by the new credit are completed. Houses must be sold, mines must begin to produce ore, factories must begin to operate and produce consumer goods.

But because consumption patterns have either remained unchanged or have become more present-oriented, by the time these new capital projects are finished and begin to produce, the

producers find no market for their goods. Because the coordination between savings and consumption was severed through the artificial lowering of the interest rate, both savers and borrowers have been signaled into unsustainable patterns of economic activity. Resources that would have been used in productive endeavors under a regime of market-determined interest rates are instead shuttled into endeavors that only after the fact are determined to be unprofitable. In order to return to a functioning economy, those resources which have been malinvested need to be liquidated and shifted into sectors in which they can be put to productive use.

Another effect of the injections of credit into the system is that prices rise. Because credit functions as money, the effect of creating new credit is the same as printing new money. More money chasing the same amount of goods results in a rise in prices. And that rise in prices affects different groups of people in different ways. Wall Street always is the first to benefit from the new credit, because it is injected by the Fed directly into the financial system. From there it trickles down through the economy, but Wall Street and the banking system gain the use of the new credit before prices rise. Main Street, however, sees the prices rise before they are able to take advantage of the newly-created credit. The purchasing power of the dollar is eroded and the standard of living of the American people drops.

We live today not in a free market economic system but in a "mixed economy", marked by an uneasy mixture of corporatism; vestiges of free market capitalism; and outright central planning in some sectors. The folly of central planning that should have been learned after the fall of the Soviet Union never took hold in Washington. Each infusion of credit by the Fed distorts the structure of the economy, damages the important role that interest rates play in the market, and erodes the purchasing power of the dollar. Markets see the interest rate and assume that the price is functioning as it should, when in fact it is being manipulated by a select few bureaucrats in Washington. Fed policymakers view themselves as wise gurus managing the economy, yet every action they take results in economic distortion and devastation.

The concept of the free market suffers as a result, since markets see a façade of market-determined prices as well as the reality of economic crisis. Wall Street makes out like bandits, while Main Street continues to suffer. The negative effects of manipulated interest rates are readily apparent in the economic malaise we are suffering now, but the real cause of this crisis, the Fed's centrally planned mismanagement, remains artfully concealed. Unless Congress gets serious about reining in the Federal Reserve and putting an end to its manipulation, the economic distortions the Fed has caused will not be liquidated; they will become more entrenched, keeping true economic recovery out of our grasp and sowing the seeds for future crisis.



Testimony of James Grant
Editor, Grant's Interest Rate Observer
Before the House Subcommittee on
Domestic Monetary Policy and Technology
United States House of Representatives
September 21, 2012

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SEPTEMBER 7, 2012

What the chairman didn't mention

An undramatic reading of 19 pages of double-spaced text lifted stocks, bonds, commodities and non-dollar monetary assets on the Friday before Labor Day. In a few short hours, the price of gold rallied by more than the \$35 per ounce at which it was officially valued between the mid-1930s and the early 1970s. The text, "Monetary Policy since the Onset of the Crisis," and the mind of the man who recited it, the chairman of the Federal Reserve Board, are the subjects at hand.

"Self-parody and self-plagiarism, neither intentional, are the bugbears of the aging author," wrote Whitney Balliett, the late, great jazz critic at *The New Yorker*. The readers of *Grant's* don't need to be told. The aging Ben Bernanke has been saying one thing, your aging editor another for a decade. We persist because he persists, and because monetary ideas have consequences. If we're right about the chairman's message, danger and opportunity are staring the holders of dollar-denominated assets right in the face. We write to try to sort out risk and reward.

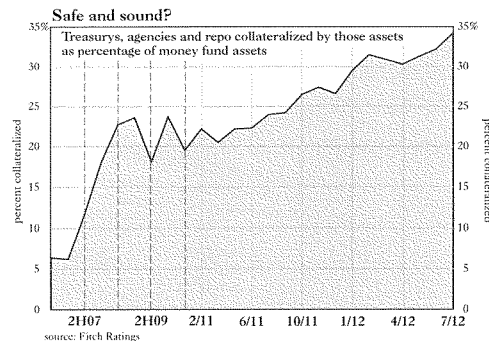
It's old news, though worth repeating for emphasis, that the Jackson Hole, Wyo., address broadly hinted at a further radical monetary stroke. "The stagnation of the labor market in particular is a grave concern," warned Bernanke, "not only because of the enormous suffering and waste of human talent it entails, but also because persistently high levels of unemployment will wreak structural damage on our economy that could last for many years. Over the past five years, the Federal Reserve has acted to support economic

growth and foster job creation, and it is important to achieve further progress, particularly in the labor market. Taking due account of the uncertainties and limits of its policy tools, the Federal Reserve will provide additional policy accommodation as needed to promote a stronger economic recovery and sustained improvement in labor market conditions in a context of price stability."

For a trade, the market seized on the phrase, "will provide additional policy accommodation as needed." For an investment, it may profitably consider the more important and revealing words, "[t]aking due account of the uncertainties and limits of its policy tools." It makes all the difference that the chair-

man does not, in fact, take due account of the "uncertainties and limits" of his "policy tools." He may pay them lip service, as he did in his speech. But he does not really weigh the costs and benefits of doing what no other American central banker has done before. With Bernanke, as with Adm. David Farragut, it's "[d]amn the torpedoes, full speed ahead," though Farragut's aggression, unlike Bernanke's, got quick and quantifiable results.

Shining through the chairman's text is the conviction that economic problems are susceptible to a monetary solution. For every monetary-policy action, Bernanke all but said out loud, there is a predictable reaction. That is, for policy A, you may bet your boots on outcome



B. For ourselves, we have come to believe—the past five years have decided us on the question—that while policy A may deliver outcome B, it may alternatively serve up outcomes J or Q or Z—or, not inconceivably, some other result too strange to be classified under a known English letter. Especially are surprises in store for the makers of “non-traditional” policy—and for the millions on the receiving end of those inventions.

Bernanke makes no bones that he is improvising. “Large scale asset purchases,” a.k.a. QE, and the “maturity extension program,” a.k.a. Operation Twist, are, if not absolutely novel in concept, then unprecedented in scale. “[W]e were guided by some general principles and some insightful academic work but—with the important exception of the Japanese case—limited historical experience,” the chairman admitted. “As a result, central bankers in the United States, and those in other advanced economies facing similar problems, have been in the process of learning by doing.”

All of us learn by doing. To learn how to ride a bicycle, we pedal. But money has been circulating for millennia, and there is a voluminous monetary record. It is there to be read. Did the chairman or his staff consult the wisdom of the ages before deciding to muscle around the yield curve, manipulate asset values, materialize dollars by the hundreds of billions and, in general, to short-circuit the price mechanism? Not on the evidence of the four-and-a-half-page bibliography appended to the Bernanke text. To judge by this reading list, the chairman consulted no authority published before 1965. He cites relatively few sources published before the onset of the 2007 financial cave-in. His favorite authors are his employees at the Federal Reserve Board.

Perhaps not surprisingly, Bernanke and his authorities are in broad agreement on the post-2007 policy record of U.S. monetary policy. It is swell, they conclude. “After nearly four years of experience with large-scale asset purchases,” said Bernanke, “a substantial body of empirical work on their effects has emerged. Generally, this research finds that the Federal Reserve’s large-scale purchases have significantly lowered long-term Treasury yields.”

And not only Treasury yields, he goes on. QE has tamped down mortgage rates and corporate bond yields

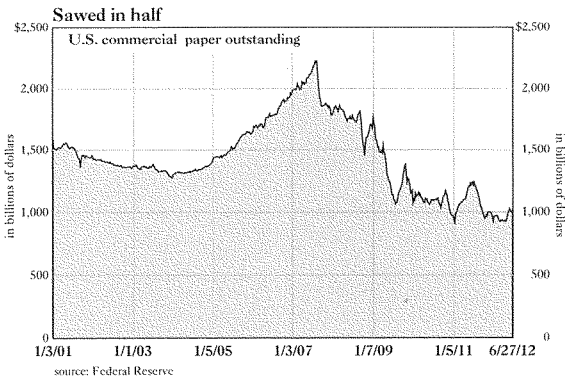
and firmed up stock prices: “it is probably not a coincidence that the sustained recovery in U.S. equity prices began in March 2009, shortly after the [Federal Open Market Committee’s] decision to greatly expand securities purchases. This effect is potentially important because stock values affect both consumption and investment decisions.”

So you didn’t build that, Mr. Market. The Federal Reserve got the rally rolling—and much to the advantage of the macroeconomic situation, too, Bernanke judged. Granted, the chairman told his audience, there’s no telling how the economy might have fared in the absence of these improvised measures. But, “if we are willing to take as a working assumption that the effects of easier financial conditions on the economy are similar to those observed historically, then econometric models can be used to estimate the effects of [QE] on the economy.” The Fed’s own models rate the Fed’s monetary policy a winner, the chairman again noted: “as of 2012, the first two rounds of LSAPs may have raised the level of output by almost 3% and increased private payroll employment by more than two million jobs, relative to what otherwise would have occurred.”

Striking the pose of a disinterested scholar, the chairman next sought to persuade his listeners that he had considered the risks, not just the rewards, of monetary experimentation. He mentioned four potential pitfalls, of which the first was the risk that the Fed’s interventions might impair the

“functioning” of the securities markets. Second was the chance that QE might frighten the uninitiated into doubting the Fed’s ability to normalize policy without seeding a new inflation. Third was the risk to “financial stability” presented by the temptation to reach for yield in these times of pygmy interest rates. Fourth was the possibility that the Fed might suffer a market-loss “should interest rates rise to an unexpected extent” (a slightly disingenuous point given the 2011 accounting change that shifts the burden of absorbing financial losses away from the Fed and onto the Treasury; on this little-reported innovation, so handy for an activist and leveraged central bank, the chairman was silent). All these risks the chairman discounted.

Omissions from the Bernanke checklist of unintended consequences and undesirable side effects, though they received no press, deserve the attention of every investor. He said nothing about the distortions wrought by the so-called zero-percent interest rate policy on the allocation of capital or on the analysis of investment value. Neither did he acknowledge how the whisking away of interest income has punished savers and nudged them into unsuitable risk taking. Though quick to claim credit for the decline in mortgage rates or the rise in stock prices, Bernanke was characteristically mute on the Fed’s contribution to resurgent prices of commodities and farmland. We commend to the chairman the cover story in the August 18 issue of *The*



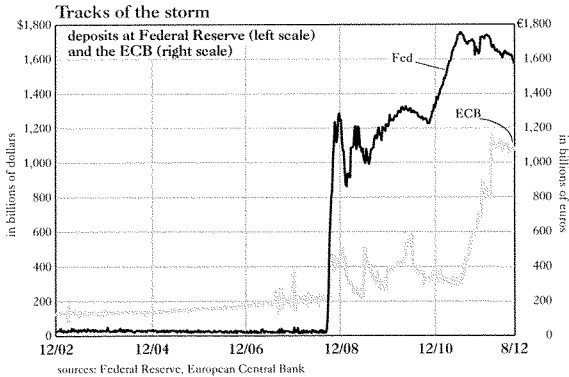
Spectator, published in London. "Hunger strikes," says the headline: "Rising food prices will mean more revolutions."

With a lot more time and a little more candor, Bernanke could have held forth for hours in this vein. The crisis-era money market alone could have afforded him all the material he needed. Zero-percent interest rates and blanket FDIC guarantees of bank deposits have reconfigured what used to be a market in short-dated IOUs of the private sector. Today's money market is increasingly a market of short-dated IOUs of the public sector.

Before the rains came in 2007, money market mutual funds earmarked just 6.2% of their assets for Treasury securities, agency obligations and repurchase obligations collateralized by the same. As of last report in July, according to an Aug. 29 bulletin from Fitch Ratings, such holdings weighed in at 34.2% of money-fund assets. Midway in 2007, \$2.2 trillion of commercial paper—unsecured corporate promissory notes—was outstanding. Less than half of that amount is issued today. As Bernanke did not get around to saying in Jackson Hole, zero-percent interest rates obviate the value of credit analysis. When a given claim yields nothing, the prudent investor will roll Treasury bills or—functionally the same thing—lay up deposits at a too-big-to-fail bank.

Zero-percent interest rates may impart no credit information, but that doesn't mean they're inexpensive. "Be afraid, Mr. or Ms. Investor, because the government is afraid," is the subliminal message. It's a suggestion that the post-crisis regulatory regime powerfully reinforces. The 2010 amendments to Rule 2a-7 of the Investment Company Act of 1940, for instance, slap tough new liquidity tests on money market mutual funds. They require that 10% of the assets of a taxable fund be held in cash, U.S. Treasuries or securities that convert to cash the next business day. And they require that 30% of the assets of a taxable fund be placed in securities that mature within 60 days or that convert to cash within five business days. Pre-crisis, the money-fund managements decided such matters for themselves.

Post-crisis, the government has its knives out, and the new rules push the funds into the least remunerative spots on the nearly barren money market credit and liquidity curves. Thus, the smaller funds face starvation, the big-



gest funds malnutrition. Nancy Prior, president of Fidelity's Money Market Group, the nation's largest, told readers of the June issue of *Money Fund Intelligence* that "we monitor every single dollar, every hour," and that there are no fewer than 80 Fidelity money market credit analysts on the case, some of whom "can hop on a plane or a train and be in Germany, Brussels or France in an hour." It is, however, travel, overhead expense and man-hours expended in the service of delivering a 0.01% return, pretax, to the investors in Fidelity Cash Reserves.

That ultra-low interest rates tend to beget even lower—and more dysfunctional—rates is another side effect of zero-percent rate policy that the chairman didn't talk about. He could have cited the example of the European Central Bank, which in July shaved the rate it pays on bank deposits to zero percent from 25 basis points. By this adjustment, Mario Draghi, president of the ECB, presumably expected to drive money out of his vaults and into the receding European economy. But the funds have stayed put while other yields have actually turned negative. It stands to reason that repurchase rates on the highest quality collateral would be quoted at less than zero if that collateral itself—short-dated notes issued by the governments of Germany, Denmark and Switzerland, for instance—yields zero percent or less. As optimism has a life of its own, so does pessimism, and the central bankers are having a

hard time cheering up the glum and broken-spirited survivors of the panic of 2008. They'll have an even harder time of it after the €1.1 trillion European money-market industry starts passing along negative interest rates to its hapless investors, as FT.com is reporting the funds are preparing to do.

In June 2011, Jamie Dimon put a question to Bernanke at a banking conference in Atlanta. The CEO of JPMorgan Chase & Co. asked the chairman if the regulatory and market response to the financial crisis might not be hurting recovery rather than helping it. Regulators are tougher, credit committees are tougher and examiners are tougher, Dimon observed. "Has anyone bothered to study the cumulative effect of all these things?" he posed.

Bernanke replied that he, for one, was gratified by how thoroughly the government had scoured the system. As to Dimon's question, he answered that no one had attempted to study the cumulative effect of so much rule and policy making and that, in truth, "it's just too complicated, we don't really have the quantitative tools to do that." And the chairman had a most revealing afterthought. He had a "pet peeve," he said, about people insisting that "the single cause of the crisis was 'x.'" There was not a single cause of the crisis," Bernanke went on. "There were many, many different causes, and they interacted in a way that was in many ways unpredictable, and led to the disaster that we experienced."

So, after all, the chairman was prepared to concede that outcomes are unpredictable, that financial systems are complex and that policies implemented for one purpose can wind up serving another. Yet the very same Bernanke, speaking at Jackson Hole, talked up the new federal crisis-prevention bureau, the Financial Stability Oversight Council, as if it had powers of divination never before available to the federal bureaucracy. "We have seen little evidence thus far of unsafe buildups of risk or leverage," he said, "but we will continue both our careful oversight and the implementation of financial regulatory reforms aimed at reducing systemic risk."

Market economies excel at identifying and repricing error. Regimented economies, in contrast, are ill suited to making mid-course corrections, as the only thing the Dear Leader despises more than error is the messenger who tells him about it.

America's Dear Leaders are the functionaries who are busily substituting bureaucracy for the price mechanism. Nowadays, when things go pear-shaped, Chairman Bernanke is front and center with broad hints to print enough money or suppress enough prices or inflate enough assets to make us forget our troubles. Don't worry that QE or Twist

or ZIRP will end in inflationary tears, Bernanke counseled at Jackson Hole: "The FOMC has spent considerable effort planning and testing our exit strategy and will act decisively to execute it at the appropriate time."

But, of course, Mr. Market doesn't hand out wristwatches. It isn't the Fed's efforts or good intentions one doubts, but its judgment. As for our judgment, as fallible as anyone's, we expect that our drugged bond markets will give no helpful signal that the central banks of the world have over-cranked the printing presses. The radical monetary experiments of 2012 will strike posterity as the most obvious setup to a virulent inflation there ever was, except that our monetary mandarins had no clue it was happening.

In 1921, O.M.W. Sprague, author of "History of Crises under the National Banking System," contributed an essay on the Federal Reserve, then just seven years young, to *The American Economic Review*. In it, Sprague, a Harvard professor, warned against the temptation to print one's way out of cyclical trouble. The Fed had hugely expanded the nation's money and credit to help the Treasury finance America's participation in World War I. There had been a rip-roaring infla-

tion. And now came the time to undo the inflationary damage. What, if anything, could the new central bank do to smooth the process of adjustment?

"If we insist upon using such power as a means of temporary relief and stimulation," wrote Sprague, "ultimate disaster is the certain consequence. Past experience shows that it is dangerous for governments to issue paper money. There is a constant temptation to overissue when confronted by real or imaginary emergencies. The same danger arises in the case of the [R]eserve system—that public opinion and perhaps legislative action will compel the employment of its resources in a vain endeavor to cure evils which are mainly due to credit already granted in excess."

Now comes Chairman Bernanke, a Harvard man himself, doing exactly what Sprague warned against, and with the support of the 21st-century economics establishment. *Grant's* is betting on a new inflation with a flight of investable funds from the assets that are today deemed safe (notably, sovereign debt) to assets deemed *infra dig* or permanently impaired (for instance, precious metals and equities). Anyway, "nontraditional" central banking is a short sale.

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**HEARING OF THE SUBCOMMITTEE ON
DOMESTIC MONETARY POLICY & TECHNOLOGY**

Statement and Testimony of Lewis E. Lehrman

Chairman, The Lehrman Institute

Prepared for September 21, 2012 Hearing

- I. Preface: The Problem of Federal Reserve Manipulation of Interest Rates:
What is the Solution?
- II. Oral Statement for the Record
- III. Full Statement for the Record: A Road to Prosperity

**I. Preface: The Problem of Federal Reserve Manipulation of Interest Rates:
What is the Solution?**

The Federal Reserve System has in fact manipulated interest rates since the first year of Federal Reserve operations in 1914. Professor Allan Meltzer's magisterial, three-volume history of the Fed is the definitive witness to unrestrained Federal Reserve credit operations and their consequences. The problems created by Fed interest rate manipulation are very similar to the problems of government wage and price controls.

During the 1920s the Federal Reserve collaborated with the Bank of England in suppressing interest rates, leading to the worldwide stock market boom and 1929 crash. Excessive Fed credit expansion and interest rate manipulation between 1996 and 1999 led to the wild tech-stock market boom during those years, and the subsequent collapse of the stock market between 2000 and 2002. The Fed suppression of interest rates between 2002 and 2005 led to the stock market, commodity, and real estate boom during those years; then the rise of interest rates, engineered by the Fed, causing an inverted yield curve; followed by the financial and economic collapse of 2008.

The extravagant and unprecedented Fed credit policy of Quantitative Easing, now intensified by QEIII announced Thursday, September 13, is one more extraordinary experiment in central bank interest rate and credit manipulation (money printing). These episodes of interest rate suppression and excessive Fed credit expansion -- with effects similar to wage and price controls -- have well-studied precedents in earlier economic and financial history. For example, the effects of the President Nixon-Arthur Burns (chairman of the Fed) credit expansion (1970-1973); and their wage and price controls of 1972 led to the collapse of financial markets in 1973 and 1974, and the worst economic decade in American history since the Great Depression. Indeed, during the late 1970s, the highest interest rates and inflation in American history were the ultimate result of previous Federal Reserve credit expansion, and government wage and price controls. The effects of substantial Fed interest rate suppression and credit expansion have, in the end, led to inflation of food prices -- or oil, or natural resources, or real estate, or equities; or in the 1970s consumer price inflation -- followed by a fall.

The most important economic and monetary issue before the Congress is how, through institutional reform of the Fed and the monetary system, to solve this Fed-created monetary problem of cyclical booms and busts -- largely the results of unrestrained Fed interest rate manipulation and quantitative easing (money printing).

In my oral testimony and statement, I shall briefly focus on the problems caused by Federal Reserve interest rate manipulation and quantitative easing -- moreso on the solution to the problem.

Herewith, in my longer, written testimony, I shall concentrate on a detailed solution to the problem.

Lewis E. Lehrman
September 21, 2012

II. Oral Statement for the Record

Mr. Chairman:

James Grant has described the consequences of Federal Reserve quantitative easing and interest rate suppression and manipulation. From Mr. Grant's analysis, one concludes that the Fed's unlimited power to purchase Treasury debt and financial market securities not only funds the Treasury deficit with newly printed money; but the Fed's market intervention process also makes of the financial class, with special access to the Fed, privileged investors and speculators. A well-connected financial class, subsidized by the Federal Reserve, is a crucial cause of increasing inequality of wealth in America. In this regard, I cite only one fact for the Monetary Subcommittee to contemplate: -- Since the termination of dollar convertibility to gold in 1971, the financial sector has doubled in size as a share of the American economy; but the manufacturing sector has been cut in half.

In 2002 Mr. Bernanke described the Fed's extraordinary power to create new money and credit in our present financial regime of inconvertible paper money and inconvertible bank deposit money. I quote Bernanke:-

"Under a fiat (that is, paper) money system, a government (in practice, the central bank in cooperation with other agencies) should always be able to generate increased nominal spending and inflation, even when the short-term nominal interest rate is at zero. The U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost."

In effect, as James Grant wrote, the Fed is not only the American central bank but, with this exalted power to print money, the Fed is now the government's central planner.

During the Volcker years from 1979 to 1987, Fed interest manipulation was justified as the means to end inflation. By 1994, employment as a Fed target had all but disappeared from the minutes of Fed meetings. Now in 2012, despite inflation being again on the rise, employment is, as a practical matter, the sole target of quantitative easing. The Fed and its apologists in the media and the academy, justify Quantitative Easing and its unlimited scope and duration, as the way to restore economic growth -- surely an extraconstitutional form of fiscal spending through Federal Reserve capital allocation. But so soon as one examines the Fed balance sheet, which few politicians do, one sees that the Fed primarily buys Treasury securities and mortgage-backed securities, in effect a subsidy by which to finance the government deficit and to refinance bank balance sheets, that is to say, the promotion of more financial and consumption-sector growth.

The problem of the American economy is neither underconsumption, nor underbanking. The problem is the lack of rapidly growing investment in domestic production and manufacturing. Investment is the necessary means by which to enable our producers to lead in both domestic and global markets. Rapidly increasing investment and production growth begets employment growth, and with it, healthy, unsubsidized consumption growth.

It is a truth of economic theory and practice that rising personal and family real income grow from increasing per capita investment in innovative businesses, new plant, and equipment. So, the question is: in reforming the Fed, how can our runaway central bank be harnessed by the financial markets to target the goal of economic growth through increased productive investment, not the promotion of consumption and Treasury deficit funding by means of quantitative easing? The answer is transparent: - the Congress of the United States has the exclusive constitutional power (under Article I, Sections 8 and 10) not only to establish the definition of the dollar; but Congress also has the power to define by statute the eligible collateral that the Federal Reserve may buy and hold against the issue of new money and credit. Thus, a simple congressional statute -- defining sound commercial loans as the primary eligible collateral for discounts and new credit from the Fed -- would have two primary effects.

First, it should rule out Fed purchases of Treasuries, thus requiring the government to finance its deficits not with newly printed Fed money, but instead in the open market away from the banks. Second, the Fed would then become a growth-oriented central bank by which to finance productive business loans, encouraging thereby the commercial banks, themselves, to make loans to businesses in order to sustain economic and employment growth. Commercial banks would focus on production and commercial loans because solvent business loans could then be used by commercial banks as the primary eligible collateral by which to secure credit from the Fed as the lender of last resort. In a word, Treasury subsidies at the Fed should be replaced by productive business loans oriented toward economic and employment growth.

Mr. Chairman, this simple, proposed reform of the Fed was the very monetary policy insisted upon by Carter Glass, a leading Democrat, who was the chief sponsor of the Federal Reserve Act of 1913. The congressional legislative leaders who created the Federal Reserve Act of 1913 designed the Fed to enable steady commercial investment and employment growth. The Federal Reserve Act was also designed explicitly to uphold and maintain a dollar convertible to gold in order to maintain a reasonably stable, general price level. Such a Fed reform today, consistent with the original Federal Reserve Act, would require no further legislative mandate to sustain employment growth and to rule out systemic inflation and deflation.

Today, the Fed reiterates at every meeting that the central bank must manage interest rates to fulfill a congressional mandate to maintain reasonable price stability and reasonably full employment. The best way to do this is remobilize the express intent and techniques of the original Federal Reserve Act, namely the statutory requirement that the Fed uphold the classical gold standard; and, as was intended by the original Federal Reserve Act, to substitute commercial market credit for Treasury debt as the primary eligible collateral for bank loans from the lender of last resort, the Federal Reserve System.

May I say, with respect Mr. Chairman, Congress has defaulted to the Federal Reserve System, its sole constitutional authority to regulate the value of the dollar and to define the vital economic use of eligible collateral to obtain productive business credit from the Federal Reserve System.

It does not have to be this way.

Lewis E. Lehrman
September 21, 2012

III. A Road to Prosperity: The Case for a Modernized Gold Standard

Gold, a fundamental, metallic element of the earth's constitution, exhibits unique properties that enabled it, during two millennia of market testing, to emerge as a universally accepted store of value and medium of exchange, not least because it could sustain purchasing power over the long run against a standard assortment of goods and services. Rarely considered in monetary debates, these natural properties of gold caused it to prevail as a stable monetary standard, the most marketable means by which trading peoples worldwide could make trustworthy direct and indirect exchanges for all other articles of wealth.

The preference of tribal cultures, as well as ancient and modern civilizations, to use gold as money was no mere accident of history. Nor has this natural, historical, and global preference for gold as a store of value and standard of measure been easily purged by academic theory and government fiat.

Gold, by its intrinsic nature, is durable, homogenous, fungible, imperishable, indestructible, and malleable. It has a relatively low melting point, facilitating coined money. It is portable and can be readily transported from place to place. Gold money can be safely stored at very low cost, and then exchanged for monetary certificates, bank deposits, and notes -- convertible bills of exchange that efficiently extended the gold standard worldwide.

Like paper money, gold is almost infinitely divisible into smaller denominations. But paper money has a marginal production cost near zero. Producing gold money, like other articles of wealth, requires real labor and capital.

This investment of real labor and capital gives gold an objectively grounded value on which to base proportional exchanges -- a value that can be compared to that invested in producing a unit of any product or service. Prices for goods and services always vary with subjective preferences. But the real costs of production persist as an underlying market-price regulator. Despite subjective preferences, a mutual exchange of real money -- a gold monetary unit -- for a good or service is a transparent, proportional, equitable exchange, grounded by real costs of production, namely labor, capital, and natural resources.

In contrast, almost no marginal labor or capital is required to produce an additional unit of paper money. Thus, legal tender paper money is subject only to quantitative control and the discretion of political authorities. Historical evidence shows that inconvertible paper money is overproduced, tending always toward depreciation and inflation, interrupted by bouts of austerity and deflation. Over the long run, government-forced and spurious paper money has not maintained equitable exchanges between labor and capital. Market exchanges based on depreciating paper money and floating paper currencies issued through the banking system always lead to speculative privilege of insiders, generally the financial class.

Because of its imperishability and density of value per weight unit, gold can be held and stored (saved) permanently at incidental carrying costs. Precious metal monetary tokens (gold and silver) survived millennia of experiments with inferior alternatives such as shells, grains, cattle, tobacco, base metals, and many others. These alternatives are either consumable, perishable,

bulky, or of insufficient value for large-scale commercial exchange over long distances. For example, perishables like wheat or cattle are not storable for long periods at very low cost; nor are they portable cheaply over long distances to exchange for other goods; nor are they useful and efficient to settle short- and long-term debts promptly.

Through a process of long-term economic evolution in tribal, interregional, and national trading markets, gold's natural properties were discovered and utilized in almost all cultures. Gold thus became universally marketable and acceptable as the optimum long-term store of value, uniform standard of commercial measure, and durable medium of exchange. Universal marketability and acceptability is a hallmark of global money. Silver, with its much lower value per unit of weight, was the suboptimal monetary metal of modern civilization, exhibiting many but not all of the properties required for large-scale international exchange.

Merchants, bankers, farmers, and laborers may not have consciously considered these facts, but over the long run, they behaved as if they did. Thus gold became an unimpeachable, universally accepted currency, to be held as reserves and passed on as a reliable store of future purchasing power. People, even hostile nations, freely accepted gold, a non-national currency, from one another in exchange for other goods, even as they rejected the sovereign risk of holding national currencies as their exclusive reserves. All who cherished the value of their saved labor -- pensioners, working people, those on fixed incomes -- came to rely on the gold monetary standard as a stable, long-term proxy for goods and services to be purchased later, perhaps much later.

Today's global stock of aboveground gold in all its forms is approximately 5 to 6 billion ounces, perhaps more -- close to one ounce per capita of the world population. Because of gold's lasting value from time immemorial, and the human incentive to conserve all scarce resources, these 5 to 6 billion ounces represent most of the gold ever produced. Yet the aboveground gold stock today may be enclosed in a cube of approximately 70 feet on each side. Gold may be easily converted to substantial amounts of monetary coin to underwrite convertible paper money and bank deposits or convenient exchange in the market.

Moreover, the empirical data demonstrate that the stock of aboveground gold has grown for centuries in direct proportion to the growth of population and output per capita. The average, annual, long-run growth of the stock of gold in the modern world is approximately 1.5 percent. This remarkable fact accounts for the unique, long-run stability of its purchasing power. New output of gold money, joined to its rate of turnover, is sufficient for both economic growth and long-run stability of the general price level, as modest but regular output of gold does not affect the relative value of the large existing stock.

This hidden but crucial commercial equation of the social order was a fundamental reason why the true gold standard, i.e., gold-based money, became the foundation of the monetary institutions of modern civilization. Gold-based money not only stabilized the long-term price level, but its network effects also integrated and compounded the rapid growth of the advanced, competitive trading nations of the Western world during the Industrial Revolution. For the purpose of global trade, exchange and investment currencies convertible to the universally acceptable gold monetary standard had engirdled the earth by the beginning of the 20th century.

As the technology and productivity of the payments mechanism evolved, banknotes and checking account deposits (among other credit and transfer systems), came into modern circulation as substitutes for physical, monetary tokens. But these banknotes and checks derived and sustained their value from the fact that everyone knew they were credit instruments convertible to gold. Still, actual gold transfers were used to settle residual balance-of-payments deficits among nations, a necessary and efficient international adjustment mechanism by which to rebalance domestic and international trade and exchange.

Despite legal tender inconvertible paper money and the disabilities presently imposed on gold by the political authorities, gold retains the same inherent properties that make it the least imperfect monetary standard. Indeed, all inconvertible paper money systems, based on contemporary fractional reserve banking, use the vestigial forms but not the substance of their original convertible currency systems.

In sum, gold is natural currency, not least because it provides in a single, indestructible substance the primary functions of money -- i.e. a standard unit of account, a stable medium of exchange, a stable store of value, and a stable deferred means of payment. By reason of these facts, the market guided the authorities over time to bestow on gold coin the status of an official monetary standard. Gold money was, moreover, endowed by nature with profound but simple national and international networking effects, the digital standard by which free prices could be communicated worldwide. Thus, the gold standard exhibited natural economies of global information scale, a necessary virtue in the present electronic age. The adoption of the gold standard by the major trading nations in the 19th century led to a radical reduction in the settlement costs of international trade and transactions, a crucial confidence and reliability factor stimulating an unparalleled boom in trade that was constantly and promptly rebalanced by residual deficit settlements in gold.

A Just Social Order and Economic Growth

To choose or to reject the true gold standard is to decide between two fundamental options: on the one hand, a free, just, stable, and objective monetary order; and on the other, manipulated, inconvertible paper money, the fundamental cause of a casino culture of speculation and crony capitalism, and the incipient financial anarchy and inequality it engenders.

Restoration of a dollar convertible to gold would rebuild a necessary financial incentive for real, long-term, economic growth by encouraging saving, investment, entrepreneurial innovation, and capital allocation in productive facilities. Thus would convertibility lead to rising employment and wages. Economic growth would be underwritten by a stable, long-term price level, reinforced domestically by a rule-based, commercial and central banking system subject to convertibility, and internationally by exchange rates mutually convertible to gold. Consider the past decade of hyper-managed paper currencies and manipulated floating exchange rates wherein American annual economic growth fell to an anemic 1.7 percent. Under the classical gold standard (1879–1914), U.S. economic growth averaged 3 to 4 percent annually, the equal of any period in American history.

Different growth rates are not mere accidents of history. The gold dollar, or true gold standard, underwrites, among other things, just and lasting compensation and purchasing power for

workers, savers, investors, and entrepreneurs. It prevents massive, recurring distortions in relative prices created by manipulated paper currencies and floating exchange rates, which misallocate scarce resources. It suppresses the incentives for pure financial speculation, everywhere encouraged under manipulated paper currencies and floating exchange rates. It rules out the “exorbitant privilege” and insupportable burden of official reserve currencies, such as the dollar and the euro. It limits and regulates, along with bankruptcy rules, the abuse of fractional reserve banking that is commonplace under inconvertible paper-money systems. It minimizes the enormous premium exacted by the banker and broker establishment in the purchase and sale of volatile foreign exchange.

Moreover, the lawfully defined gold content of a stable currency encourages long-term lending and investment, stimulating more reliance on equity, less on leverage and debt. With currencies convertible to gold, long-term lenders receive in turn, say after 30 years, similar purchasing power compared to the capital or credit they surrendered to the borrowers. (Convertibility thus encourages stable long-run domestic and international growth, not the austerity engendered by deficits.)

A dollar legally convertible to gold, reinforced by effective bankruptcy law, sustains economic justice, regulating and disciplining speculative capital, and restraining political and banking authorities such that they cannot lawfully depreciate the present value or the long-term purchasing power of lagging dollar wages, savings, pensions, and fixed incomes. Nor under the sustained, legal restraint of convertibility can governments ignite major, long-run, credit and paper money inflations with their subsequent debt deflations. Under the gold standard, the penalty for excessive corporate and banking leverage is insolvency and bankruptcy. As the profits belong to the owners, so should the losses. Bankruptcy of insolvent firms shields the taxpayer from the burden of government bailouts. Under the rule-based gold standard in a free-market order, managers, stockholders, and bondholders must bear the responsibility for insolvency.

A stable dollar, convertible to gold, leads to increased saving not only from income, but also from dishoarding, a fact often neglected by economists. Dishoarding means releasing a vast reservoir of savings previously held in hedges such as commodities, antiques, art, jewelry, farmland, or other items purchased to protect against the ravages of inflation. These trillions of savings, imprisoned in hedging vehicles by uncertainty and inflation, are induced out of hedges, and the capital is then supplied in the market to entrepreneurs, business managers, and households who would create new income-generating investment in production facilities, thereby leading to increased employment and productivity. On the other hand, central bank subsidies to government and subsidized consumption, both enabled by inconvertible paper and credit money, lead -- through deficit financing, transfer payments, paper money fiscal and monetary stimulation -- to disinvestment, debt financing, speculative privilege, and growing inequality of wealth.

It is rarely considered by conventional academic opinion that the long-term stability of a rule-based currency convertible to gold brings about a major mutation in human behavior. In a free market every able-bodied person and firm must first make a supply before making a demand. This principle effectively alters human conduct. It encourages production before consumption, balances supply and demand, rules out inflation, maintains balanced international trade, and upholds the framework for economic growth and stable money. In a free market and its banking

system, grounded by the rule of convertibility to gold, new money and credit may be prudently issued only against new production or additional supply for the market, thus maintaining equilibrium between total demand and total supply. Inflation is thereby ruled out. Moreover, worldwide hoarding of real assets, caused by government overissue of paper money, would come to an end.

The irony of the gold standard and currency convertibility is that it ends speculation in gold. It restores the incentive to use and hold convenient, convertible paper currency and other gold-convertible cash balances. Thus can the road to economic growth, rising real wages, and growing employment be rebuilt on the durable foundation of a free monetary order -- that is, money free from government manipulation.

Rebalancing the Global Economy

The overall balance-of-payments of a country, or a currency area, is in deficit when more money is paid abroad than received; a surplus occurs when more money is received than paid abroad. The United States, because of the dollar's role as the reserve currency of the world, has experienced an overall balance-of-payments deficit most of the past half-century and, over that full period, systemic inflation.

Under both the Bretton Woods agreement (1944–71) and the subsequent floating, dollar-based, global reserve currency system, the U.S. budget and balance-of-payments deficits have been financed substantially by U.S. government trust funds, the Federal Reserve, and foreign purchases of dollars abroad. Since 2008, these deficits have been accompanied by unprecedented quantitative easing, a euphemism for large-scale central bank money and credit creation (or “money printing”). By this means the Fed finances not only the government budget and balance-of-payments deficits, but also overleveraged banks, insolvent debtors, and other wards of the state. The issue of new money by the central bank unaccompanied by the production of new goods and services leads ultimately to inflation because total demand in the market will exceed total supply.

With the dollar as the reserve currency, the U.S. balance-of-payments deficit causes Fed-created dollars to rush abroad, directed there by relative price differences. In foreign countries, many of these excess dollars are monetized by foreign authorities and held as official foreign exchange reserves. But these reserves are not inert. They do not lie around in bank vaults. They are in fact reinvested in the U.S. dollar market -- especially in U.S. government securities sold to finance the federal budget deficit. In effect, the United States exports its debt securities, thus receiving back the dollars it created and used to settle its balance-of-payments deficits abroad. Everything goes on as if the deficits didn't exist. No adjustment is required of the United States to settle its debts, or to rebalance the deficits with surpluses. Thus again, total demand is enabled to exceed total supply. In a word, the world dollar standard enables America to buy without really paying, a fundamental cause of inflation. But when the Federal Reserve slows or ends quantitative easing, or money printing, total monetary demand declines and deflation threatens.

Rebalancing world trade is impossible under an official reserve currency system. (The International Monetary Fund and the central banks are pathetic shadows of “all the king's men” trying to put Humpty Dumpty -- that is, global rebalancing -- back together again.) This perverse

international monetary system, whereby the reserve currency country issues its own money to finance and refinance its increasing deficits and debts, augments global purchasing power and potential worldwide inflation, because the newly issued central bank money is not associated with newly produced goods and services. Total demand has been divorced from supply. When total demand exceeds total supply, inflation usually occurs first in marketable, scarce commodities, equities, and inflation hedges (2009–2012); other more general price level effects may be deferred because of unemployed labor and other unutilized resources in excess supply. But ultimately, the general price level will rise as the economy approaches full employment. (The worldwide panic demand for the dollar over the past two years, during the European crisis, has mitigated the general price level effect of quantitative easing. The desire to hold the dollar in cash equivalents rather than to spend or invest it defers inflation.)

Under the rule-based gold standard, the regular settlement of balance-of-payments deficits eliminates a root cause of global imbalances, re-establishing equilibrium among trading nations. Under the true gold standard, residual payments deficits could no longer be settled in newly issued national paper and credit monies, such as the reserve currencies of the dollar or euro. Instead, these deficits would be settled with an impartial, non-national monetary standard: gold. The requirement to settle in gold rules out the exponential debt increases of flawed reserve currency systems. A famous example of this is the flawed gold-exchange-reserve currency system of the 1920s, the collapse of which turned a recession into the Great Depression. Another case is the financial bubble and its collapse during the past decade (2002–2012).

Moreover, it is very much in the American national interest to terminate the reserve currency role of the dollar. This role is an insupportable burden borne by the United States since the end of World War II (even since the great powers' Genoa agreement of 1922). The U.S. taxpayer should no longer go further into debt in order to supply the world with dollar reserves denominated in U.S. debt. Terminating this burdensome "privilege," combined with the restoration of dollar convertibility to gold, will gradually end the long era of extreme global trade imbalances, secular debt accumulation and inflation, and currency depreciation. Furthermore, because the reserves of monetary authorities will be held only in gold and domestic currency claims, the exchange-rate risk will be eliminated in all national banking systems.

The rule-based, true gold standard not only would end the official reserve currency role of the dollar, but also limit arbitrary Federal Reserve money issuance secured by spurious, defective, and illiquid collateral. Unstable mutations in the gold standard of the past -- including the failed reserve currency-based "gold-exchange" system of Bretton Woods and the collapse of its predecessor, the reserve currency-based "gold-exchange system" of the 1920s and 1930s -- must be ruled out. So, too, must floating exchange rates. For almost a century, policymakers, politicians, historians, and economists have confused the flawed, interwar gold-exchange standard, based on official reserve currencies, with the true or classical gold standard. They have mistakenly blamed the Great Depression on the gold standard, instead of on the liquidation of the official reserve currencies underpinning the gold-exchange system established at Genoa in 1922, which, like Banquo's ghost, reappeared in 1944 in the form of the Bretton Woods system.

The Bretton Woods pegged exchange rate system, based on the official reserve currency role of the dollar, collapsed in 1971 because the United States had accumulated more short-term debt to foreigners than it was willing to redeem in gold. Its collapse ushered in the worst American

economic decade since the 1930s. The unemployment rate in 1982 was higher even than the unemployment rate occasioned by the collapse of the Fed-induced real estate bubble of 2007–09. Similarly, the recession of 1929–30 became the Great Depression of the 1930s because of the collapse and liquidation of the interwar official reserve currency system, based as it was on the pound and the dollar. The liquidation of official sterling and dollar currency reserves deflated the world banking system: Without these foreign currency reserves the banks were forced to deleverage, call in loans, or go bankrupt. They did all three.

Since 1971, the floating exchange rate system, or the world dollar standard, has been even more perverse and crisis-prone than Bretton Woods and the Genoa interwar system. The dollar's role as the reserve currency has caused not only extreme inflation and the subsequent threat of deflation, but also industrial and manufacturing displacement in the United States. It has resulted in declining American competitiveness, one witness of which is the collapse of the international net investment position of the United States (essentially, U.S. assets held abroad, less foreign assets held in the United States). In 1980, the U.S. net international investment position was 10 percent of GDP. In 2010 it was negative 20 percent of GDP. The difference was equal to the increase of foreign-held official dollar reserves, arising from continuous U.S. balance-of-payments deficits under the dollar-based official reserve currency system.

Under the present system, the perennial U.S. balance-of-payments deficit will, more often than not, continue to flood foreign financial systems and central banks with undesired dollars, followed by brief periods of dollar scarcity, the threat of deflation, and a cyclical rise of the dollar on foreign exchanges. Foreign authorities may continue to purchase excess dollars against the issue of new domestic money. This duplicates potential purchasing power unassociated with the production of new goods, causing total demand to exceed total supply -- thus tending to sustain worldwide inflation, generally followed by recession and the threat of deflation. So-called sterilization techniques designed to neutralize central-bank money printing are not fully effective. Without monetary reform, the excess dollars purchased by foreign central banks, reinvested in U.S. government securities and other dollar debt, will continue to finance excess consumption and rising government spending in the United States.

Today inflation of the general price level (or CPI) proceeds gradually in the United States because of unemployed resources, combined with the panic demand worldwide to hold the dollar rather than spend it, or to repay debt with the money rather than to consume. At full employment, inflation will pick up. Because the reserve currency system generally leads to a rapid increase in global purchasing power, without a commensurate increase in the supply of goods and services, the systemic tendency of the reserve currency system is monetary expansion or inflation. Yet the process can work dangerously in reverse, causing deflation, especially when the Fed tightens, or there is panic out of foreign currencies into the dollar (the Asian crisis, 1996–2002, and the euro crisis, 2012). Illiquidity abroad can cause foreign official dollar reserves to be resold or liquidated in very large quantities, reducing the global monetary base, as occurred in 1929–33 and recently in 2007–09.

In the absence of government rules that favor inconvertible paper and credit money, the historical evidence shows that gold, or paper and credit money convertible to gold, was preferred and accepted in trade and exchange from time immemorial. Until recent times the gold standard also underwrote, indeed required, global trade rebalancing, now the subject of empty

exhortations by the International Monetary Fund and political authorities. But to desire a goal without the effective means to attain it -- namely, the true gold standard -- is to court political and financial disaster. In the absence of prompt balance-of-payments settlements in gold, the undisciplined official reserve currency systems have immobilized the international adjustment mechanism. The result has been increasing trade imbalances, ever-rising debt, and credit leverage at home and abroad. Under the world dollar standard, other nations have gained desired dollar reserves only as the United States becomes an increasingly leveraged debtor through balance-of-payments deficits. Whereas under the gold standard, the global economy may actually attain balance-of-payments surplus as a whole vis-à-vis worldwide gold producers.

Among its monetary virtues as the least imperfect monetary system of civilization, the true gold standard, without official reserve currencies, is the sole rule-based monetary order that reliably and systematically rebalances worldwide trade and exchange among all participating nations.

How to Get From Here to There

Step 1. The president announces unilateral resumption of the gold monetary standard on a date certain, not more than four years in the future. Unilateral resumption means that the U.S. dollar will be defined by law as a certain weight unit of gold. The Treasury, the Federal Reserve, and the entire banking system will be obligated to maintain the gold value of the dollar. On the date of resumption, Federal Reserve banknotes and U.S. dollar bank demand deposits will be redeemable in gold on demand at the statutory gold parity. Further use by foreign governments of the dollar as an official reserve currency will entail no legal recognition by the United States.

Step 2. The president issues an executive order eliminating all taxes imposed on the buying, selling, and circulating of gold. Another executive order provides for the issuance of Treasury bonds backed by a proportional weight of gold. Since Federal Reserve notes and bank deposits (money) are not taxed by any jurisdiction, the executive order specifies that gold, being legal tender, is to be used as money and thus to go untaxed. Gold can be used to settle all debts, public and private. The Treasury and authorized private mints will provide for the creation and wide circulation of legal tender gold coin in appropriate denominations, free of any and all taxation.

Step 3. Shortly after announcing the intent to go forward to a modernized gold standard, the United States calls for an international monetary conference of interested nations to provide for the deliberate wind-up of the dollar-based, official reserve currency system and the consolidation and refunding of foreign official dollar reserves. The international agreement to be negotiated will inaugurate the reformed international monetary system of multilateral convertibility of major countries' currencies to the gold monetary standard. Stable exchange rates would be the result. The value of each participating currency would be a function of its stipulated gold parity.

Step 4. The conference, attended by representatives of the Bank for International Settlements, International Monetary Fund, World Trade Organization, and the World Bank, would establish gold as the means by which nations would settle residual balance-of-payments deficits. The agreement would designate gold, in place of reserve currencies, as the recognized international monetary reserve asset. Official foreign currency reserves, to a specified extent, would be consolidated and refunded.

Step 5. A multilateral, international gold standard -- the result of the conference convertibility Agreement -- would effectively terminate floating and pegged-undervalued exchange rates. The reformed monetary system without official reserve currencies, the true international gold standard, would establish and uphold stable exchange rates and free and fair trade, based upon the mutual convertibility to gold of major national currencies.

Now we are able to formulate an authentic, bipartisan program to restore 4 percent American economic growth over the long term. Tax rate reductions with an enlarged tax base, government spending restraint aimed at a balanced budget, simplification of business regulation designed to empower entrepreneurial innovation -- these reforms can be made effective for America and the world by a modernized gold standard and stable exchange rates. This is the very same platform which uplifted 13 impoverished colonies by the sea in 1789 to leadership of the world in little more than a century.

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