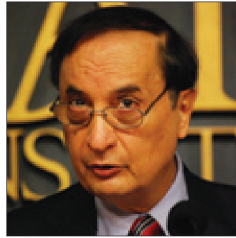
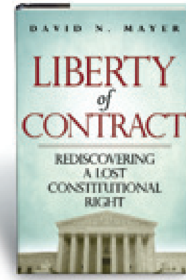
WILLIAM H. PATTERSON
Heinlein's biographer visits Cato
PAGE 5



GEORGE TAVLAS
Financial warnings from Greece
PAGE 12



LIBERTY OF CONTRACT
Law schools teach a folktale
PAGE 3

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Easy Money and the Decapitalization of America

BY KEVIN DOWD AND MARTIN HUTCHINSON

In the Gospel of Matthew, Jesus recounts the Parable of the Talents: the story of how the master goes away and leaves each of three servants with sums of money to look after in his absence. He then returns and holds them to account: the first two have invested wisely and give the master a good return, and he rewards them. The third, however, is a wicked servant who couldn't be bothered even to put the money in the bank where it could earn interest; instead, he simply buried the money and gave his master a zero return; he is thrown into the darkness, where there is weeping and wailing and gnashing of teeth.

In the modern American version of the parable, the eternal truth of the original remains—good stewardship is as important as it has always been—and there is still one master (the American public), albeit a master in name only, who entrusts his capital to the stewardship of his supposed servants. Instead of three, however, there are now only two (the Federal Reserve and the federal government); they are not especially wicked, but they certainly are incompetent: they run amok and manage to squander so much of their master's capital that he is ultimately ruined, and it is he rather than they who goes on to suffer an eternity of wailing and teeth-gnashing, not to mention impoverishment. For their part, the two incompetent servants deny all responsibility, as good politicians always do, and—since there is no accountability (let alone biblical justice) in the modern version—ride off into the sunset insisting that none of this was their fault.

FUTURE ASSET BUBBLES?

The Federal Reserve is supposed to be a monetary servant, but its masters in the general public don't seem to be able to control it. Its actions keep distorting returns in the economy and creating bubble after bubble.

Continued on page 6

KEVIN DOWD is a visiting professor at the Pensions Institute at Cass Business School in London and an adjunct scholar at the Cato Institute. **MARTIN HUTCHINSON** is a former banker, correspondent for Reuters BreakingViews, and author of the weekly column "The Bear's Lair." They are coauthors of *Alchemists of Loss: How Modern Finance and Government Intervention Crashed the Financial System* (Wiley, 2010). This article is based on their paper for the Cato Institute's 28th Annual Monetary Conference, "Asset Bubbles and Monetary Policy."

H. L. Mencken Research Fellow P. J. O'ROURKE speaks at the Cato Institute on November 3. The event concluded a five-city tour for his new book, *Don't Vote: It Just Encourages the Bastards*, with stops in Dallas, Houston, Los Angeles, San Francisco, and Washington.

> “Federal Reserve monetary policy over the past 15 years or so has produced bubble after bubble, and each bubble is bigger and more damaging.”

Continued from page 1

Since past expansionary monetary policies led to bubbles, we should expect the even more expansionary policies pursued since the onset of the current financial crisis to produce new bubbles, and this is exactly what we find. Within the United States there are at least three very obvious bubbles currently in full swing, each fuelled by the flood of cheap money: Treasury bonds, financial stocks, and junk bonds. We can be confident that these bubbles will come to unpleasant ends like their predecessors, but on a potentially much grander scale. The bubbles will then burst in quick succession.

We have to consider also the nontrivial knock-on effects: the Treasuries collapse will trigger an immediate financing crisis for governments at all levels, and especially for the federal government, one that will likely involve the downgrading of its AAA credit rating, and so further intensify the government's by-then already chronic financing problems. Nor should we forget that these financial tsunamis are likely to overwhelm the Federal Reserve itself: the Fed has a highly leveraged balance sheet that would do any aggressive hedge fund proud; it too will therefore suffer horrendous losses and is likely to become insolvent. The events of the last three years will then look like a picnic.

There is also the problem of resurgent inflation. For a long time, the United States has been protected from much of the inflationary impact of Federal Reserve policies: developments in IT and the cost reductions attendant on the outsourcing of production to East Asia had the impact of suppressing prices and masking the domestic impact of Fed policies. Instead, these policies have produced a massive buildup in global currency reserves: these have increased at 16% per annum since 1997–1998 and caused soaring commodity prices and rampant inflation in countries such as India (current inflation 16%) and China (maybe 20%, judging by wage inflation, and definitely much higher than official figures acknowledge), whose currencies have been (more or less) aligned to the dollar. U.S. inflation was already rising by 2008 (annual rate 3.85%), but this rise was put into reverse when bank lending and consumer spending then fell sharply. However, the huge additional monetary overhang created over the last couple of years (or, to put it more pointedly, the vast recent monetizations of government debt) must eventually flood forth—and, when it does, inflation is likely to rise sharply.

Once inflation makes a comeback, a point will eventually come when the Fed policy has to go into sharp reverse—as in the late 1970s, interest rates will be hiked upwards to slow down monetary growth. The consequences would be most unpleasant: the U.S. would experience the renewed miseries of stagflation—and a severe one at that, given the carnage of a renewed financial crisis and the large increases in money supply working through the system. Moreover, as in the early 1980s, higher interest rates would lead to major falls in asset prices and inflict further losses on financial institutions, wiping out their capital bases in the process. Thus, renewed inflation and higher interest rates would deliver yet another blow to an already gravely weakened financial system.

THE DECAPITALIZING EFFECTS OF REPEATED BUBBLES

Federal Reserve monetary policy over the past 15 years or so has produced bubble after bubble, and each bubble (or each group of contemporaneous bubbles) is bigger in aggregate and more damaging than the one that preceded it. Each bubble destroys part of the capital stock by diverting capital into economically unjustified uses—artificially low interest rates make investments appear more profitable than they really are, and this is especially so for investments with long-term horizons: that is, in Austrian terms, there is an artificial lengthening of the investment horizon. These distortions and resulting losses are magnified further once a bubble takes hold and inflicts its damage, too: the end result is a lot of ruined investors and "bubble blight"—massive overcapacity in the sectors affected. This has happened again and again, in one sector after another: tech, real estate, Treasuries, and now financial stocks, junk bonds, and commodities—and the same policy also helps to spawn bubbles overseas, mostly notably in emerging markets right now.

We also have to consider how periods of prolonged low (and often sub-zero) real interest rates have led to sharply reduced saving and, hence, to lower capital accumulation over time. U.S. savings rates have fallen progressively since the early 1980s, falling from nearly 12% to a little over 6% by the end of the decade, bottoming out at 1.4% in 2005. It then recovered somewhat, but even after the shock of 2008, the savings rate rose in 2009 to only 5.9%—well below its long-term average of about 8%—and the most recent data suggests that it is now declining again.

Even without federal budget deficits, it is manifestly obvious that such savings rates are inadequate to provide for the maintenance, let alone growth, of the U.S. capital stock (or, for that matter, its citizens' desires for a secure retirement): the U.S. economy is effectively eating its own seed-corn. Now add in the impact of federal budget deficits of around 10% of GDP and we see that the deficits alone take up more than the economy's entire savings, without a penny left over for investment. It then becomes necessary to supply U.S. capital needs by foreign borrowing—hence the persistent and worrying balance of payments deficits—but even this borrowing is not enough. Hence over the long term, low interest rates are

decapitalizing the U.S. economy, with damaging long-term implications for its residents' living standards: in the long run, low interest leads to low saving and capital decline, and they in turn lead to stagnation and eventually to the prospect of declining living standards as America ceases to be a capital-rich economy.

Not to put too fine a point on it, savings have been suppressed for close to two decades, preventing the natural accumulation of capital as baby boomers have drawn closer to retirement, while much of the country's magnificent and once unmatched capital stock is being poured down a succession of rat holes.

> "Savings have been suppressed for close to two decades, preventing the natural accumulation of capital as baby boomers have drawn closer to retirement."

THE FEDERAL GOVERNMENT DESTROYS CAPITAL

We should also see these problems in the context of a vast number of other government policies that are decapitalizing the U.S. economy. The wastefulness of government infrastructure projects is an obvious case in point. One instance is the Amtrak proposal for a Boston-Washington high-speed railroad, costed at $118 billion, compared to $20 billion equivalent for similar lines in France and under $10 billion for a line recently opened in China. Even more striking is the ARC tunnel project between Manhattan and New Jersey, recently killed by Gov. Chris Christie because of its excessive cost of $8.7 billion plus likely overruns. Yet the Holland Tunnel, performing an identical function and opened in 1927, came in at $48 million, equivalent to $606 million in 2010 dollars. Even allowing for the higher real wages of today's construction labor, and a certain amount of fiddling of the consumer price statistics by the Bureau of Labor Statistics, it should have been possible to bring the ARC project in at under $2 billion, less than a quarter of the actual projected cost. The high costs of infrastructure problems boil down to the onerous regulations under which such projects are carried out, such as the Davis-Bacon mandate to use union labor on federally funded projects and a whole welter of health, safety, and environmental regulations.

We also have to consider the impact of government fiscal policy. Large government deficits reduce capital accumulation insofar as they crowd out private investments; large levels of government debt also reduce capital accumulation in that they imply large future burdens on taxpayers, and these burdens reduce their ability (not to mention their willingness) to save. The government's deficits have risen from 1.14% of GDP in 2007 to a projected 10.64% of GDP in 2010. In the process, U.S. government official gross debt has grown from almost 64% of GDP in 2007 to a little over 94% of GDP in 2010. The rate at which it is rising would suggest that the U.S. government's credit rating will soon be threatened, even without the prospect of an imminent Treasuries collapse; indeed, this figure alone portends a rapidly approaching solvency crisis.

Yet even these grim figures are merely the tip of a much bigger iceberg. The official debt of the United States, large as it is, is dwarfed by its "unofficial" debt: the prospective expenditures on entitlement programs—Social Security, Medicare, Medicaid, food stamps, and more—to which the federal government has committed itself, but not provided for—that is, additional debts that future taxpayers are expected to pay for. Recent estimates of the size of this debt are hair-raising. Using CBO figures, Laurence Kotlikoff recently estimated that this debt was now $202 trillion. That is 15 times the "official" debt and nearly 14 times annual U.S. GDP—implying that the average U.S. citizen would need to work almost 14 years simply to pay off this debt: no wonder Kotlikoff concluded that the United States is in fact bankrupt. This burden implies punitive tax rates on future employment income (and hence major disincentives to work or at least to declare income), but will also greatly discourage future capital accumulation as investors will (rightly) fear that there is little point building up investments that will eventually be expropriated by the government.

LONG-TERM OUTLOOK FOR THE U.S. ECONOMY

The long-term effect of U.S. economic decapitalization will not necessarily be apparent in day-to-day headlines; instead, the process will be almost glacial: mostly slow but utterly devastating in its longer-term impact.

Americans might also take heed from the experiences of other once-wealthy countries whose economies were crippled by progressive decapitalization:

- Britain was a wealthy country at the very frontier of technological advance in the late 1930s. However, when World War II broke out, the government took complete control of the economy and seized its entire capital stock, foreign investments and all. Over the next decades a bloated state sector and onerous controls deprived British industry of the capital it needed to refit, and the country went into long-term economic decline. By the late 1970s Britain was being referred to as the new "sick man of Europe," and British living standards were 30% lower than Britain's European competitors' and half those in the United States.
- Argentina, one of the world's wealthiest economies in 1930, with enormous foreign exchange reserves from wartime trading as late as 1945, embarked on wildly extravagant schemes of corruption, nationalization, and income redistribution under its 1946–1955 dictator

Juan Perón. Once Perón was removed, successive governments tried to restore Argentina's position—it was after all superbly endowed with resources and in the 1940s had a highly competitive education system—but without adequate access to capital were unable to do so. The result was progressive impoverishment, repeated debt defaults, and the country's descent into its continuing socialist squalor.

"Monetary reform on its own will not be enough to reverse the destruction of U.S. capital: the federal government also needs to reform its own vast range of capital-destroying policies."

WHAT CAN BE DONE?

Thankfully, such a dire future is not inevitable, but radical reforms will be needed if it is to be avoided. Any reforms need to be based on a diagnosis of the underlying problems, and one of the most important of these is, quite simply, that U.S. policymakers place too much emphasis on the short term and fail to take adequate account of longer-term consequences. Nor should this be any surprise: the political environment in which they operate—including the fact that they are accountable over limited terms of office—encourages them to focus on the short term, so it is only to be expected that they would respond to such incentives: what happens after their watch is not their problem.

As far as monetary policy is concerned, these short-termist incentives create an inbuilt expansionary bias that has manifested itself in repeated asset price bubbles and now the prospect of renewed inflation, and the solution is to build in barriers to contain this bias. The key here is to reduce or—better still—eliminate the Fed's discretionary powers; this would put a stop to those who would meddle with the short-term interest rate and would thus head off the asset bubble cycle at its root. Interest rates would then be higher (and more stable) than they have been over recent years and so provide a stronger incentive for saving.

One possible reform would be to end the Fed's "dual mandate" and give it a single overriding objective—namely the maintenance of price stability—and reform its institutional structure to protect its independence from the federal government. Reformers could take their lead from the late lamented Bundesbank: instead of a federated central bank accountable to the federal government and headquartered in the federal capital, the American central bank could be reconstituted as a unitary central bank accountable to the states and relocated in the heartland of the nation: our recommended choice would be St. Louis, which also has the attractions of a strong monetarist tradition and of being less susceptible to the influences of Washington or Wall Street. The ideal Fed chairman would then be more concerned with the *St. Louis Post-Dispatch* than the *Washington Post* or the *Wall Street Journal*, and even the feeblest appointee would be strong enough to stand up to the badgering of east coast politicians and financiers.

A far better reform—and a far more appropriate one, given the Fed's dismal record since its founding—would be to abolish the Federal Reserve altogether and re-anchor the dollar to a sound commodity standard. A natural choice would be a gold standard, with the currency issued by commercial banks but pegged to and redeemable in gold. Interest rates and money supply would no longer be determined by central bankers but by market forces subject to the discipline of the gold standard. An alternative anchor might be some broader commodity basket, which has the additional attraction of promising greater price-level stability than a gold standard.

Yet monetary reform on its own will not be enough to reverse the destruction of U.S. capital: the federal government also needs to reform its own vast range of capital-destroying policies. Such reforms would include, among others, the following: (1) Government should stop meddling in the financial system; it should stop such programs as mortgage guarantees and deposit insurance, implement measures to prevent future bailouts, and abolish government-supported enterprises such as Fannie Mae and Freddie Mac, whose machinations have devastated the U.S. housing market. (2) Reformers should acknowledge the tendency of government to grow and to be excessively focused on the short term, and should push for a systematic program that will sharply reduce the size and scope of government and limit any future growth. (3) A range of tax reforms is needed to abolish tax-based incentives to borrow and remove tax penalties from saving, investing, and the transfer of capital between generations. (4) Government should tackle major budget imbalances. This requires a reversal of current expansionary fiscal policies and, for once, the United Kingdom provides a positive role model: the U.K. faces similar problems, but the new U.K. coalition government acknowledges these problems and is in the process of implementing major cutbacks to take Britain back from the brink. The United States needs to do the same.

The longer-term fiscal prospects for both countries are of course dire, but the good news is that most actuarial deficits are not so much hard-and-fast debt obligations as projections of what will happen if current policies persist. There are obvious economies that can be made once the U.S. government finds the courage to tackle these problems. Were we given to flippant remarks, we would be tempted to suggest that the situation is "desperate but not serious"—and more tea parties would be a good start. But then, being British ourselves, we would approve of tea parties, wouldn't we? ■