Episode 373 – How to Rein in the Fed, Right Away
Guest: Joe Salerno
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WOODS: I am very happy to hear that your paper, your proposal for reining the Fed, is now in the top 10 downloaded papers over at SSRN, the Social Science Research Network, and I am hoping with the old Tom Woods Show bump, we might be able to get her up to number one. That would be fantastic to see.

I have to say that the reason I wanted to have you on—I would have had you on if I had found out you had a paper in the top 10 anyway, but this particular paper is one of these things that every once in a while changes my mind on something. At some point, you reach middle age, you're pretty much set in your ways, but this did actually change my mind on what the best way forward against the Fed is. It's hard for to think of, by the way, how to title this episode because if I say four-step plan for reining in the Fed, people will say, "Reining in the Fed? I want to end the Fed." Of course, we all do, but in the short run, what sorts of things can we do? And what you do in this paper at the very beginning is introduce the concept of Fed independence and then evaluate how that's actually worked out. So why don't you do that here.

SALERNO: In the 1980s and 1990s, there was a lot of research by Fed economists or by monetary economists in general into what makes low inflation rates, and the consensus was that it was Fed independence or central bank independence. Now, whenever you had a central bank that was substantially independent of politics, you had very good inflation performance. They did a little bit more research or a lot more research in the 1990s, and they even came up with a conclusion that Fed independence also led to less variability in inflation. That is, the inflation number didn't jump around as much. They were low and steady, and you didn't get much business cycles. In other words, low inflation went along with an absence of a lot of economic fluctuation in real output, especially when you had independence of the central banks. So in any case, that became the textbook story. That became the conventional narrative that was given to students in textbooks, to the journalists who then reported it through the media, and so Fed independence or independence of the central bank became the new orthodoxy.

WOODS: And when we talk about the independence of the central bank, we are talking about the central bank's ability to formulate monetary policy without oversight by political bodies.

SALERNO: Right, without any oversight by, in a democracy, for example, the legislature in the U.S., by Congress.

WOODS: But then, now, this was the conventional wisdom, that this has had good results, and it makes intuitive sense that we should have the experts running the show and so on and so forth, and then the housing bust happens and suddenly and dramatically, opinion begins to change. Talk about that.

SALERNO: Yes, one thing before I start talking about that. They even coined a term for this outcome of so-called central bank independence. They called it The Great Moderation. They said from 1985, 2005, and even in 2006 they were talking about it, that there was this tremendous moderation that could really only be completely explained by independence of central banks, and then the next year we began to have people recognizing the bubble, the bubble popping in housing, in financial markets, and we got the financial crisis. So just when they were becoming very self-celebratory and celebrating the fact that central bank independence had paid off in a very big way with very low inflation and very few business cycles, you got the financial crisis.

WOODS: So what you're doing in this paper, then, is attacking the idea of Fed independence, and of course, you can even attack the Fed independence from another level. You can argue that, really, the Fed is not really fully independent anyway, because we all know that if there were a war or a depression or whatever, it's impossible to imagine the Fed operating in a way completely contrary to the will of the U.S. government. But nevertheless, it does maintain some kind of façade, anyway, of independence, and certainly, the Congress doesn't set monetary policy, but you're proposing, well, let me let you explain it. What are you proposing be done that would be different from what we have now in terms of the making of monetary policy and the creation of money?

SALERNO: Well, what I would like to see done, at least in the short run to rein in the Fed, and its excesses, is to have Congress in effect set the budget for the Fed. In other words, not permit the Fed to intervene in financial markets, not to have the Fed independently create money to buy government bonds, so it would be pretty much folded into the Treasury department. It would not be legally permitted to purchase any bonds or any sort of asset on financial markets. So we would shut the Fed out of financial markets. It would no longer distort interest rates. If the money was to be printed, then it would be due to the Treasury requiring the Fed to print a certain amount of money in exchange for these what might be called Treasury bonds, but not really Treasury bonds, just orders to the Fed to print out a certain amount of money to finance the Treasury deficit. So the Fed is financing Treasury deficits now, but in a very indirect and very destructive way, which winds through the banking system and financial markets and distorts interest rates and causes business cycles. We would cut that out directly. It would also have the virtue of making monetary policy much more transparent. We would now know if the politicians in Congress and the president's budget and so on—if there was an excess of tax revenues, then we could all clearly see, lay people and so on, that the money was being printed up by the Fed to finance spending on certain pet projects of politicians, and I think that's a positive virtue.

WOODS: I want you to explain simply how it is that this approach tackles the problem of the business cycle—that you still get some discoordination created by artificial increases in the money supply, but it's the way the money enters the system that affect whether or not you're going to get a business cycle as a result, but explain that for especially people who are not economists, but are just intelligent laymen.

SALERNO: Right now what happens is that if the Fed wants to expand the money supply, it does so by going to 20 or 30 primary dealers, basically privileged banks, Goldman Sachs and so on, even some foreign banks. And every morning between 9:00 and 11:00 a.m. there's an auction, an auction in which they will pay for bonds. They pay for these bonds that are sold to them by the banks by creating money or creating bank reserves. It's actually not even printed up. It's just simply they go into cyberspace, they make an entry into their accounts, and they say, well, you now have $100 million dollars more in exchange for the bonds that you sold us. So anytime the Fed buys anything, it prints money to do so, and it is legally permitted to do so. At that point, the bank now has $100 million more in reserves, and they bought our interest on it. So then it goes to the markets, and it will try to loan this out, but it cannot loan it out at the current interest rate. It has to lower its interest rate in order to attract borrowers for that additional $100 million. When that happens and the money gets into circulation, it's spent. You have inflation, but at the same time, you have much lower interest rates, and that point, businesses who are borrowing then begin to undertake spending on capital goods.

They begin to distort the economy by driving up the prices of capital goods, drawing labor and other resources into producing more factories, more mines, more and more equipment of all sorts, and that causes an imbalance in the economy, and so you move resources to an area where they are not serving consumer wants, and eventually that's reversed. When interest rates go back up, it's not as profitable, they find out, to have invested in those various production processes, and at that point, there is unemployment, they stop spending as much in those areas, and there is not only unemployment, but a lot of the equipment then is not used, and that's called a recession, and that liquidates these problems. Now, by the way, the Fed was printing up reserves of about $85 billion during the period of the height of quantitative easing. Every month $85 billion new dollars of reserves will be added to the banking system, which could then be loaned out, and would then be multiplied in increasing the money supply that you and I actually hold and spend.

WOODS: So what we're dealing with would be in place of the way the Fed creates money these days where it enters the economy via the banking system and with this process of lowering interest rates, which creates a cascading effect of problems throughout the economy, we would have what Mises called “simple inflation,” where the Treasury would create the money and just use it to pay the salaries of bureaucrats or just spend it right into the economy. Those are the two models?

SALERNO: Yes, that’s the key thing, Tom. So if the Treasury has a deficit of $1 trillion, it would then go to the Fed, which was now really part of the Treasury, and it would just give them an order or give them so-called bonds for a trillion dollars. The Fed would print the trillion dollars up, hand it to the Treasury. It would not go through—it would bypass financial markets. The Treasury would then begin to pay bureaucrats, to spend on its favored projects and its favored constituencies, and you would have inflation, and that’s a very bad thing, and there are distortions that go along with it, but you wouldn't have a characteristic boom, that is, inflation during which everybody thinks they are really prosperous and then a crash, a business cycle precipitated by, let’s say, a financial crisis. Things would be much more transparent, and people would see what’s going on, and there would be no distortion of the interest rate.

WOODS: Joe, let me tell you why it was hard for me to accept this. I have spent a little bit of time here and there, and even in an AERC presentation, going after people we sometimes call the Greenbackers. These are people who want to end the Fed because they think it’s not inflationary enough, and they believe that the correct populist approach is indeed to put the money creation process in the hands of our so-called elected representatives. And in a way, this sounds like the same thing you are advocating, and they are advocating it specifically in order to get more inflation than before. What do you say about that? Are there safeguards against that? Why should I be supporting what the Greenbackers are supporting, in other words?

SALERNO: Well, here’s what I think. I think this is only part of our program. I think there’s a grassroots movement against the Fed. There’s a backlash against the Fed, and I think that we can take advantage of it by pushing for this program in which Congress assumes the role of controlling the money supply, which is what is in the Constitution, but at the same time, that’s not to say that we can’t push our campaign forward on all fronts. So you also want deregulation. You also want Congress to end legal tender laws. So I think this could—and of course, get rid all sorts of taxes: capital gains, excise, sales taxes on all potential alternative currencies like gold, silver, and even foreign currencies. So I think this is all part of the program of taking back our money, taking it back from unelected, unaccountable bureaucrats and then putting pressure on Congress. Congress is the body that will respond to the public. For example, if you wanted the NSA to stop spying on the American people, would you go and try to lobby the head of the NSA and try to get him to impose rules on himself? Of course not. You would go to Congress. And I think this is the way that we have to proceed. So I don’t agree with the Greenbackers’ ends, but I do agree with some of their means. The means are to pressure Congress.

WOODS: And of course, another thing that you would be reining in the Fed from doing is not just its creation of money, but also its discretionary policy pertaining to bailouts. Bailouts would have to be all carried out in full view right before the public with people who are, at least in some way, answerable to the public, even if it's largely a façade. At least somebody is answerable for these sorts of programs and bailouts that we saw in the wake of the financial crisis.

SALERNO: Yeah, exactly, Tom. Now there would be—it would be transparency, as you said, and there would be names attached to the bailouts. We would know. There would be congressional hearings and so on. We would know who is getting the bailouts. They would have to go before Congress and request the bailouts. So you wouldn't have this tremendous secrecy that we had for so many years before we finally got the information via a Bloomberg freedom of information suit against the federal government. This will be in plain view from the beginning to the end, so I think that would put the reins on the Fed as bailer-outer of last resort.

WOODS: Let me just read a couple of sentences from that section of your paper. You say, "First of all, there would be no need to bail out pure depository institutions, because all such institutions would hold 100% reserves. But second, even if purely financial, non-money-issuing institutions were in danger of failing, the decisions to bail them out would be made by an openly partisan Treasury under the watchful eye of the congressional opposition and in full view of the public." Now, let me go back to that first sentence there. How does this program of yours involve depository institutions holding 100% reserves? Where does that step come in?

SALERNO: Well, I think since the banks are really an arm of the federal government at this point in the sense that they are fully protected by federal deposit insurance, I think that there would be no problem—I wouldn't have any reasons for objections to the federal government or, I guess, Congress, mandating that if banks want to create dollars or create checking accounts, that they would do so only on the basis of 100% reserves. That's the old Chicago plan of Milton Friedman's teachers, and they push for 100% reserves against fiat money—against fiat-denominated checking accounts and so on. So that could be part of the plan. It wouldn't necessarily have to be part of the plan, because once you deregulate it, once you got rid of federal deposit insurance and so on, at that point, I think the banks would show more restraint, but I think initially that that would be part of what I would be advocating.

WOODS: I am curious, by the way, Joe, what part of Chicago analysis requires—well, I guess it doesn't require—but would make sense for them to advocate 100% reserves. I understand the fiat money thing, but what kind of pitfalls do they think they are preventing by having a 100% reserve system? What do they think are the problems with a fractional-reserve fiat money system, the Chicago people I mean?

SALERNO: The Chicago people would say that if you have 100% reserves, then the central political monetary authority, whether it's Congress or whether it's the central bank, would be able to completely control the money supply. The money supply would not fluctuate, for example, if households took currency out of the banks, right? Because it would be one-for-one. There would be no money creation by the banks, or there would be no problem with banks holding 100% reserves and reducing the so-called money multiplier. In other words, complete control of the money supply would be by the entity that was supposedly in charge of monetary policy. So we are certainly not in favor of that. We don't want 100% reserves because we want the federal government or the central bank that still exists to have full control of the money supply, but in effect, they would.

WOODS: Your paper is called "A Modest Proposal for Reining in the Bernanke Fed." Obviously we can substitute Yellen for Bernanke and all the names that are likely to come up in the future. This paper has gotten a lot of attention recently. It came out—it looks like it's dated August 18, 2014, but it's getting a lot of attention now. We'll link to it on the show notes page, which would be tomwoods.com/373, but just for the sake of the audience, although, I have had Jeff Herbener on to talk about what would we do once we end the Fed, I think we should at least spend a couple of final moments on what is our final preferred endgame of all of this—if we had exactly our way, and we didn't have to come up with an interim series of steps like this, where would we want to go ultimately?

SALERNO: I think ultimately you want to go back to a money that's controlled by the market, and that would have to be a useful commodity like gold or silver or whatever else the market would come up with. At that point, we would allow any sort of bank or lending institution to set their own rules for their loans and so on. There is a question whether legally there should be 100% reserves enforced, but I'll wait for a full libertarian society for the judges there to sort that question out. Right now we don't want any support for any fractional-reserve banking from the government. That is, if they want to set their own fractional reserves and promise to pay immediately or instantaneously any call for withdrawal, well, then they'll have to bear the full consequences. See, Mises was a free banker in that sense, but only because he believed that that would cause fractional-reserve banks to be very, very prudent and very, very careful about creating fiduciary media. We'd have a very slow increase in the money supply, if we had any at all, once that was put into place. But we'd have a lot of other institutions loaning money and paying interest that would take advantage of technology. We have things happening now in Sweden and other countries in which these micro loans are being made and people are putting money in for a certain period of time and earning interest, and it's not fractional-reserve banking.