Episode 1,230: Questions on Economics You're Embarrassed to Ask

- **Guest: Jeff Herbener**

WOODS: Let me run through a couple of the first ones, and then — because as I say, I feel like if somebody has this question, then chances are a chunk of people have these questions. And these are questions that maybe people feel like I better not ask, because it sure sounds like everybody already knows this stuff, and this is so elementary, I'd better not ask, like people would say — sometimes with *Contra Krugman*, people would ask Bob and me: you guys are talking a lot about treasuries, but I don't even know what that means. You know, we use this lingo like everybody in the world knows what it means, and we ought to step back and examine that lingo from time to time.

So somebody wants to know — so I say, I'll take the first couple, and unless I make a grave error, we'll assume that they're okay.

HERBENER: Not possible.

WOODS: [laughing] Well, that's very kind of you to say. He says: 'What exactly does it mean to create wealth? Does that mean mine for more gold?" When we think about creating wealth, the way I think of it would be something like this: I mean, first of all, that there's more stuff after you've created the wealth than there was before. Now, it doesn't have to be physical stuff. I suppose it could be that now I have more masseuse services than I had before.

But my thought would be something like this: that I have a business and I'm earning a profit, and I take the profit and I use that profit to buy some machine that allows me to produce more goods, more widgets than I produced before. And I can produce them with, let's say, fewer other inputs, like labor. So instead of 10 workers to produce 100 widgets, I can use 5 workers and produce 1,000 widgets. So there are a couple of consequences of this. The 5 workers I no longer need are now available to produce new things that couldn't have been produced before, because they were tied up producing widgets. So now, every extra thing those 5 people are now released to go produce is the creation of wealth. Now we have something that we did not have before.

Then, secondly, maybe it's the case that the market doesn't even need 1,000 widgets. But maybe really, I can only make selling 750 widgets really work. So whatever other resources other than labor that would have gone into the production of the extra 250 widgets are also released for use in some other project somewhere else. And that lowers the price of whatever those inputs are, because now there's more available. And so that involves an increase in wealth, because now other firms can get hold of the inputs that they need more inexpensively, because I've released a bunch of them to the market. So that's what I think of when I think of the creation of wealth. How do you feel about that?

HERBENER: Yeah, yeah, that's exactly right. So I think the key point is to reiterate that, in order to know in the social order whether wealth is being created or not, we need a metric of economizing. We need to be able to tell, like you said, whether or not profit's in the process of production that we've put into motion. And when it is, then of course, we've generated wealth. We've created wealth because the resources that have been drawn into a production process have a lower opportunity cost in other production processes than the monetary value of the output that's produced in that process. So anytime a profit is earned, losses are avoided, then we're engaged in a process of wealth creation.

WOODS: All right, let me do another. The person says — this is something that he's heard said. Quote: "The Fed kept the dollar low by lowering interest rates and flooding the market with cheap money." So I guess his actual question is about the term cheap money. He says, "Okay, cheap money, but a dollar is a dollar, so how could money be cheap?"

And the answer to that question is, when we use the expression "cheap money," what we're thinking about is, if somebody were to lend you a dollar, you couldn't just say — let's say you've lent me a dollar. I'll pay you back a dollar a year from now because after all, a dollar is a dollar. But what the issue is, is a dollar today and a dollar a year from now, you can't say a dollar today is a dollar a year from now. It's not because obviously, a dollar a year from now is not as serviceable to you. So the question is, given that no one's going to, you know, other than your friend or something — but you know, nobody's going to lend you $1 and expect just $1 back. I mean, think of it obviously, more like $10,000, because then it really would — $1, you wouldn't really notice, but with $10,000, you're not going to get a loan for $10,000 and then just repay nominally $10,000 in a year. You're going to be expected to pay maybe $10,500. That's because of the interest rate. You're going to have to pay interest on that. But if interest rates come down, then maybe you might have to pay back only $10,200. And in that sense, money has become cheaper. Not that — of course, a dollar is a dollar, but the act of borrowing money has become less expensive for you. It's less dear, because the interest payments you have to make are now lower. And that's what we mean by cheap money. So do you accept that?

HERBENER: Yeah, that's exactly right. So it's better to say cheap credit. And the idea is —

WOODS: It is. It is better to say cheap credit, yes.

HERBENER: And the conceptual distinction is that money itself really has two prices. The one that you were explaining we might call the inter temporal price. It's when people trade present money for future money, and that's what's being referred to, when people say cheap money, they're referring to the lowering of the interest rate, as you suggested, and we should better say cheap credit. And then money has a spot price, as well. The exchange value of money right now in the present against goods, the purchasing power of money. And people, when they say cheap money, don't usually mean that the purchasing power of money has gone down. They're usually talking about the temporal price of money.

WOODS: All right, now, I'm going to throw a couple over to you, also from the same person. Now, for this one, I think you need to go into how the money supply is increased, because only then can you really make sense of how it is decreased. But he says, "When you say, 'shrink the money supply,' you mean like pile up all the physical cash and burn it?"

And so, I mean, that's a legitimate question. But of course, what we're talking about here in an economy like ours is that the physical cash is not so much the issue, because that's such a small portion of the money. It's electronic money. So maybe can you explain, again, super basically what this process looks like?

HERBENER: Right, so it's a distinction, we like to say, between money proper, like you said, the physical cash, and claims to money that perform the medium of exchange function, like checking account balances, which are just claims to money that can be cashed out at par on demand. So the money stock, the total amount of the medium of exchange that people have to use to buy things, is made up of the sum of money proper plus money substitutes. And while the physical cash tends not to be destroyed, it can be augmented by the Fed's printing, but not usually actually reduced by shredding money, and so on. So most of the time when the money stock is shrinking, as you say, it's shrinking because the claims to money are shrinking. The banks are contracting that portion of the money stock.

WOODS: So let's say — I mean, basically, you have to think about the process of whereby the Fed — well, in fact, you know what? Let's go right into that. I'm going to skip right into that question, because really, in a way, to get this one, let's go back even further to what exactly is the process by which the Fed increases the money supply, number one? Because people hear this a lot, but they want to know, what does that look like? And then secondly, let's go into what does it mean when we say the Fed wants to lower interest rates. Well, what are they talking about? And then thirdly, I want to know what is the — and don't worry, I'll go over all these again. But the third one I would want to throw in there is: what is the relationship between the interest rate that the Fed targets to either lower or raise and the interest rate that I get paid on my savings account at the bank? Is there any relationship between those? So let's start with the first one of these, and heaven help me, I can't remember what it was.

HERBENER: [laughing]

WOODS: Oh, yeah: the Fed increasing the money supply. What does that actually look like? What are the steps?

HERBENER: Right. So what the Fed does in regulating the banking system and commercial banks, they set a required reserve ratio that banks have to hold against their money substitutes, their checking account balances that the bank issues. And then by changing — the Fed can engage in a process of changing the amount of reserves that the bank has by simply buying securities that the bank holds from the bank and then paying either in cash or in another form that's considered a reserve. And then the bank with more cash reserve can increase the amount of its checkable deposits, keeping the ratio between checkable deposits and reserves the same. And the normal procedure for this is the Fed buys from banks, United States Treasury certificates: bills, notes, and bonds. And the procedure is called open market operations, because the Fed operates the buying of these securities through what's called the "open market primary dealers." So that's the first brief account of the first part.

Now, on the second part about lowering the interest rate, so here we can see the effect of this, once we add in what the bank is doing to generate the additional money substitutes. How do they increase the checking account balances of the customers when the Fed has provided them with more reserve — when the banks sell Treasury securities to the Fed, they get paid in reserves. So what the bank does is simply extend loans. They just make more loans to people who they weren't lending to before the additional reserves gave them the required ability to increase their checkable deposits. So they just make loans. And they write the loan balances into the checking accounts of their customers. And so that's where the additional money substitutes come from. And the additional credits supply that the banks are just creating by issuing checking account balances, this additional supply of credit will make interest rates lower than they otherwise would be.

And then the final question about the target and the market interest rates. So the Fed conducts monetary policy with this, as they see it, a feedback mechanism. They're trying to manipulate market interest rates, but they can't directly control those. The banks are the ones that actually issue the additional supply of credit. The Fed doesn't. They haven't yet at this point, at least, completely socialized the allocation of credit. They let the banks allocate the credit. And so the effect that Fed policy has on interest rates in the market economy depends upon how the banks respond to the Fed's increasing the bank's reserves by buying securities from banks.

And so the Fed tries to manage all this with a target interest rate, and the interest rate that they target is the one that they can have direct influence over, which is the interbank overnight lending rate called the federal funds rate. This is the interest rate that banks charge each other for lending to each other reserves. And the Fed, again, buying securities from banks, can increase the supply of reserves the banks have overall to work with. And so by increasing the supply of that form of credit, they can manipulate the federal funds interest rate that can directly affect it by increasing its supply.

And then it's up to the banks to, again, expand their own commercial credit on top of those increased reserves. And how they do this — I mean, in a normal situation, they would just begin to lend more, say, into mortgages or into auto loans, or whatever it is, and then the interest rates in the market for those things, credit card interest rates and so on, would move down as the Fed's engaged in expansionary policy. But of course, this is a loose connection. The banks recently, since the financial collapse, haven't been lending in lockstep with the increase in Fed funds or reserves. And so short-term interest rates have fallen dramatically relative to long term, relative to the sort of normal interest rates when we think of as existing in the market for auto and houses and so on.

WOODS: Jeff, let me just revisit quickly the issue of shrinking the money supply again, in light of how you've described the process of expanding the money supply. Because the Fed can increase the money supply, but then, as you say, the ball is in the court of the banks. Because if the banks just sit on any additional money and they don't lend it out, then it more or less just sits there and that's the end of the process. It's the lending out of the money and the multiplication of the money by means of loans that really gets the process going. And once those loans, let's say, get repaid, if they get repaid to the bank with — because basically, the bank is creating money in the course of extending these loans.

In fact, let's stop right there. Let's stop right there. I want to make sure every step is covered here. When I say the bank is actually creating money when it extends the loans, but we've also said the Fed creates the money that the bank then creates loans off of, can you just go super-duper simple through that?

HERBENER: Right, so let's take just a concrete case to, again, make it as simple as possible. Let's say the Fed goes to a bank, and they say, "We'd like to buy a million dollars of the Treasury securities that you're holding." And the bank agrees. They negotiate a price and the bank agrees. And so the bank shifts the Treasury securities off to the Fed, and the Fed delivers a million dollars in cash to the bank. And the Fed may have just printed this money, so that would be an addition to the overall money stock. So the Fed prints the money, and they ship it by armored car to the bank.

And now the bank has million dollars of cash in its vault, but the Fed already has this reserve requirement regulation for the bank, that the bank only needs to hold a 10% cash reserve against its checking account balances overall, of all of its customers. So with one million more in cash, the bank now issued $10 million more in checkable deposits and still be meeting the 10% reserve requirement ratio. The way in which the bank gets $10 million more in the checking account balances of its customers is to extend its customers loans or to take on new customers who want loans. And then they just write the loan balance into the checking account of their customers. And they can do this to the extent of $10 million. Now, this would be the creation of, we could call this bank money or, again, the technical economic phrase is money substitute.

WOODS: All right, now, let's see. How about this question? Somebody wants to know: "When we have a recession, where does all the money go?" And what he means by that is: "The stores have the same amount of food, and there are just as many families needing to buy it. What gives?"

And that actually is a good question, because it's not like the day that it's announced that we're in recession, the physical composition of the economy has changed. It's not. It's a mispricing of things in the economy. It's the same things, but there's been an improper valuing of different things. So it's not so much that money disappears; it's that some things in the economy — it could be housing, could be stocks — that people believe to have a certain value, they believe this on the basis of — well, I hate to use "faulty information," but in a way, it is a kind of faulty information.

Sometimes it's because people caught up in a boom are giving them bad advice, or sometimes it's they're just looking at prices and they're trying to make an estimate of what their house is worth and things like that. But some of these things got their inflated prices through artificial means, and people didn't realize that, and eventually they realized that in the recession, when people all of a sudden are no longer willing to pay that much for houses, or they're no longer willing to pay that much for other goods or for corporate stock or whatever. And so these are prices then fall.

It's not that there isn't as much money anymore. It's that there's been an over-valuing of some things and undervaluing of other things for artificial reasons, because of, let's say, the intervention of a monetary authority. In the recession, you're just kind of sorting all this out and repricing factors of production, even consumer goods, in line with what consumers really want. So it's not that the stock of things has changed; it's that the way we look at them, evaluate them, evaluate their relative scarcity, whatever — that has changed. Now, how would you add to that or correct that?

HERBENER: Yeah, no, that's exactly right. There's one more element I'd add to it, and that's the change in cash holdings. So it isn't it the money disappears necessarily. I mean, it might —

as you were talking about before, some of the bank-created money might disappear in the liquidation of loans. But the main impetus toward the downward movement of prices overall is, during the recession, the increased movement that people have toward holding money as opposed to buying things. So they've extended their debt too far, and now they want to pay it down, and so they quit buying things.

And this puts even more downward pressure in a more general array of goods in the economy than you would think would occur if the phenomena were just that, well, okay, during the boom, we shifted expenditure because of all this new money into certain goods, like buying more houses, and we way boosted their prices, and had these asset price bubbles. And now we see that that's a mistake, and so we take the money out of that, and we spend it on other things. And so housing prices fall, but prices of other things to go up. So that's what you might think, without this extra element of — the movement toward liquidity, as they say in finance, or the movement toward holding cash during the recession. This, again, is a perfectly reasonable move that people make to restore their financial situation from the malinvested positions that they've taken during the boom

WOODS: Let me ask this one, because this is kind of a variation on cost-push theories of inflation. Somebody wants to know: "How exactly does a universal basic income not directly result in inflation, negating the individual monetary gains that each person would receive.?" And now, he's not saying if it's funded o through inflation; he's just saying would it of itself, because he clarifies, and says: "Maybe I have a flawed understanding of inflation, but if everyone gets $1,000 on top of their regular income, irrespective of where it comes from, doesn't that necessarily mean that $1,000 is worth less than it was worth prior to everyone receiving it? I hope this is making sense."

So let me jump in on that. If the universal basic income — let's say it is $1,000 per person. If that's paid out of just actually creating the money out of thin air, printing up $1,000 for everybody, then yes, that would mean that, since the stock of goods and the economy is unchanged and the only thing that's changed are the pieces of paper allowing you to bid on those goods, all that means is that everybody's going to bid up the prices of those goods accordingly. So that's going to be a wash.

But if it's a matter of — see, here the key thing is: irrespective of where it comes from. Well, if it came from taking money from rich people and giving it to poor people, that would not cause inflation. In the same way that if the price of oil goes up, a lot of people think that causes inflation through cost-push, because everybody uses oil for something and oil is just the lifeblood of the economy, so if the price of oil goes up, all prices will go up. The flaw in that reasoning is, if I now have to spend more money on oil because the price is higher, I have less money to spend on all other goods. And so although, yes, the price of oil goes up, there's a slight downward pressure on other prices, because I have to abstain from some of my purchases in order to be able to buy the oil I want to buy. And so it's not that all prices go up; it's that — unless, again, unless inflation is involved, unless there's an increase in the money supply. But the point is that this increase in the price of one commonly used thing doesn't bring up all other prices; it just leaves me with less disposable income to buy those other goods. And that, actually, if anything, lowers their prices.

And that's exactly what would happen in the case of just giving everybody $1,000. I mean, yeah, the people who get the thousand, they get an extra thousand in purchasing power. But the people from whom the thousand was taken lose a thousand in purchasing power, so there's no net. I mean, it could be that relative prices change, because maybe poor people spend their money on different goods from what rich people might have spent. But there's no general upward pressure on all prices.

HERBENER: Yeah, that's exactly right. I would say the only other aspect to what you were just saying there at the end, is that generally, as an empirical matter, the rich save a greater portion of their income than the poor. And so we not only see a shift of movement of, you know, higher prices for the consumer goods that are bought by poor people, but the funds taken from the richer would tend to have gone into the purchase of capital goods. And so we would also see a movement away from capital accumulation and toward more present-oriented production. It would be a reasonable supposition to make.

WOODS: Let me give you one that is — I kind of know the textbook answer, but people are saying that they're left kind of cold by the textbook answer. And that is the question of a millionaire versus somebody at the poverty line and the claim that, well, we can't make interpersonal comparisons of utility. Who's to say that the poor person values an extra dollar more than the millionaire values an extra dollar? But they're saying, look, yeah, I get that I can't compare that, and it is conceivable that the millionaire could just be insanely devoted to money and the poor person could be a monk. I get it. But it's hard to claim that a guy dying of thirst of the desert wouldn't value that dollar for the glass of water more than the millionaire would value the dollar that he'll burn, you know, as he's rolling a cigar out of it. So is there a way you can address this that would sound more convincing, I guess?

HERBENER: Well, one angle on it, I think, is just to note that what is typically being called for in redistribution of income on the basis of this kind of comparison, that the poor would get greater benefit from the income than the rich, is state coercion. They're calling for the state to forcibly take money from the rich and give it to the poor. So I think the only way you could actually demonstrate that it was advantageous to the rich to make the transfer is for it to be voluntary. Why don't we just try to persuade the rich guys trying to frivolously use money that both he and the recipient would be better off if the money was donated to the poor or, you know, transferred to someone who had a greater need for resources than the rich guy does?

WOODS: All right, let me give you a couple more, and then I'll let you go. First one is: "Where does money get its value from?"

HERBENER: Well, money gets its value, like all goods get their value, from the subjective value that people place on it in performing the function that the money performs as a means, which is the medium of exchange function. So once we have a medium of exchange, people value it for the facilitation that it provides in making their exchanges in a very efficacious way so that they can avoid the problems of barter. So in that sense, it's no different conceptually than the value for any good. Any good is valued only as a means to an end that the person valuing it desires to attain.

WOODS: And then finally, let's try this one: "What function do stock traders perform that entitles them to their profits?"

HERBENER: Stock traders in the sense of brokers and so on?

WOODS: Yeah, I guess so. I guess that's what they mean. Yeah, okay, a stockbroker.

HERBENER: Yeah, so the broker is just a middleman. And the middleman always performs the function of facilitating an exchange between two parties. And so you have one party who wants to sell shares of stock and another who potentially wants to buy them. But these two parties on their own may not know of each other; if they do know each other they may have to go through a long negotiation in order to settle on a price, and so on and so forth. And the broker, just like any good middleman, facilitates that exchange. So he brings the parties together. He maybe provides a guarantee to the parties of delivery of the goods and so on, so that their exchange can be facilitated. So there are all sorts of services that middlemen can provide that are beneficial enough for the trading persons, the persons engaged in the trade to pay for.

WOODS: It's sometimes helpful, by the way, to think — this is not directly related to the question, but to remember that the service that a bank provides in lending money is an example of a middleman. Because how would you on your own be able to go out and say to people, *All right, I know a bunch of you would like to save money, and since I'd really like to be able to find worthy projects to lend money to, I want to go up to each of you and see how much interest would I need to pay you to get you to give me some money, so that I could then go out and find creditworthy borrowers to lend it to?*

I mean, you as an individual, no way you'd be able to — and you as individual, you don't even want to do that. All you want is money for your project, or all you want is to save your money and earn some interest. That's all. You only want one half of that. But the bank finds the two halves of that equation, they find the people who want to save, they find the creditworthy projects, they bring these together without even the two sides having to know each other. The bank also performs the function of assessing the creditworthiness of the other side, so that the person saving the money doesn't have to think that much.

Now, of course, we think even less because of deposit insurance. We don't even think about the quality of the bank's portfolio. That's a separate matter. But in a genuine free market, even then, I would more or less say I can trust the specialists at the bank to make good decisions with the money. And then this is a really important and outstanding middleman service that the bank is providing. And we miss so many of these wonderful services that are provided to us because we're taught to hate and loathe and despise certain classes of people, so we don't stop to think, well, what social function are they performing? And that's what we ought to do, whether it's stockbrokers or people who trade in futures markets, let's say, and it seems like, well, gee, they're earning some profit, and I don't even get what it is that they're doing. All right, so take a few minutes to try to get it. What is the social function that they're performing?

If they're in futures markets, that just means that they're smoothing out the price level over time, so that, let's say, if they anticipate that there's going to be bad harvest coming up, well, then, instead of having the price spike, the second that bad harvest takes place, we anticipate the coming bad harvest by means of moves made in the futures markets, that we start to see prices rising now. And now we can make our plans, we can look for substitutes, whatever, because now we see the price starting to rise now, instead of this immediate and shocking price rise that would occur in the absence of futures markets that would be harder for people to cope with. So my point is simply — I'm jumping in on this just because we're not exactly taught to admire futures traders or bankers, but these two, like stockbrokers, perform functions for society that we're not exactly taught to appreciate.

HERBENER: Yeah, that's absolutely right. And just to extend your point to one step further, this middleman functioning is embedded in the activity of all entrepreneurs. They're all doing this function. They're bringing together disparate groups, who wouldn't be able to come together on their own initiative, the producers in a division of labor and the consumers of the product, and they're bringing them together for their mutual benefit. So this is a generalizable feature of the market. And just because the middlemen in financial markets are not visibly engaged in the physical activity of producing and so on, doesn't mean they're not performing this function. They are, in fact. That's an excellent point.

WOODS: All right, I'm going to let you run, because I've been doing episodes that are a little on the long side lately, and that that's fine once in a while. But I do like these to be kind of commute-length. But I think we hit — I mean, we must have hit eight questions, at least, that I am sure some folks listening have secretly wondered about, and I hope that's at least a good beginning in helping them. And of course I might add, by the way, that you teach a very, very step-by-step introduction to Austrian economics over at LibertyClassroom.com, and I also have that course available — let's see. No, no, it's not that one. Jeff also did a course where you went through a very, very popular mainstream economics textbook that's used in colleges, and you critiqued every chapter of it from an Austrian perspective. Absolutely great. So if you're not over at LibertyClassroom.com yet, you should be, because in addition to the course material that Jeff has created, you can ask Jeff questions in the forums anytime you like. If you're a basic plus or a master member, you can ask him questions, and he's an outstanding question answerer. It's just amazing. So Jeff, great talking to you. Thanks for your time.

HERBENER: You too, Tom. Thanks.