



Episode 422: How the Fed Is Helping the Few and Hurting the Rest

Guest: Mark Thornton

THORNTON: Tom, I wish you were back here at the Institute. We just brought in a new gang of summer fellows, and it's really a great group. We've got some Americans, of course, as well as a German, a Pole, a Spaniard, someone from China, someone from Brazil, someone from France. And they're just amazing so far.

WOODS: Ah, it just sounds — it just reminds me of the old days. For people listening in, I'm nostalgic any time Mark talks about this, because I was at the Mises Institute from 2006 to 2010. And the Summer Fellows Program he's talking about, it's a program in which primarily graduate students come to the Institute for the summer; they work under the direction of Mark and Joe Salerno, who's also been a guest on this show, and they work on some research project, which they then present the fruits of at the end of the summer. And they're all just topnotch people. I really felt privileged to get to know them.

And we used to have them over to the house every week. Well, we would drink like crazy, of course, but then we would also have games outdoors, sometimes games in the house, and we would play Mafia. There was one time everyone was in town for, I think, the Rothbard Graduate Seminar, possibly, and so we did Austrian Pictionary. My wife and I made a whole deck of cards of all different concepts in Austrian economics. And I remember Roderick Long doing a graphical representation of the structure of production. And I thought, hey — it was pretty good for a philosopher. Ah, those days, Mark. All right, now —

THORNTON: Those were great days, and that's the missing ingredient right there.

WOODS: That's very good of you to say. Now, look, if I start crying on the show, it's going to be a very bad first. I've made it over 420 episodes without any tears on the show. All right, let's turn to your article now. It's going to be linked on today's show notes page, which will be TomWoods.com/422, and it's called "The Meaning of Financial Repression." Very interesting — tantalizing — title there. And you begin by saying that, in a way, we're living through a series of paradoxes: we've got low mortgage rates, and yet people can't get loans. We've got unemployment rate seemingly close to full employment, and yet a record number of people don't have jobs. Set the stage for us, as you do at the beginning of your article, for what exactly

we're experiencing now, and why it's not actually a robust recovery, as the president's apologists would have it.

THORNTON: Well, you just think of it, the world that we're living in, where central banks are printing massive amounts of currency and balances on their accounts. We have extremely low interest rates. Mortgage rates are at a historical low. And yet, people that I know are not getting loans. And when I looked into it, I found that home sales are up, yes, that's true. But it's a record number of people who are buying homes with cash, rather than with the mortgage. And as you said, the unemployment rate is near full employment, and yet we have a record number of people who don't have jobs. And the Federal Reserve fretting over raising its lending rate to banks from .16th of 1% to above .25 of 1%. So we're living in this crazy, chaotic central bank world of manipulation.

WOODS: Now, when you say that home sales are up but with a near record percentage of sales made with cash, and that this is an odd trend, are you saying here that what's happening is that this fact that the mortgage rates are low seems to be benefitting only the wealthy, only people who would be in a position to put down cash for a house? Is that what you're concluding from that?

THORNTON: That's certainly one of the things about financial repression: that the end result is that benefits accrue to wealthy people, Wall Street people, big bank people, and hedge funds, as well as the government, but the rest of society, you and I, are not benefitting at all, because we're being financially repressed.

WOODS: Okay, now when you say "financial repression," elaborate on this. Is it just an environment in which the Federal Reserve is holding interest rates super low, or is there more to it?

THORNTON: Yes, they're squeezing us basically, Tom. Central banks around the world are keeping interest rates that they lend to banks near zero, and yet in the economy itself, prices are rising – 2%, they say, but probably more than that. And so if we want to put money into savings, you put it in the bank – I was just recently at my bank, and a five-year certificate of deposit would earn you .2 of 1%. Okay, so you put your money in the bank, you get .2 of 1% in interest, but when the money comes out five years later, it's going to be subject to double-digit levels of inflation. And so you're really losing money by putting your money into your savings account, certificates of deposit, money markets. They're all earning historically negligible rates of return.

And so the repressing interest rates, it hurts just about everybody: workers, savers, retirees, as well as things like pensions and the insurance industry. And so the vast bulk of society is suffering under this monetary pumping, zero interest rate environment, and look who's benefitting. The government is borrowing money – 10-year bonds that governments are issuing and in the U.S. are only like 2% rate of return. So because of the central bank money printing, they're able to borrow money at very low levels. And big corporations also benefit, as well as banks, but a corporation can go out – like Apple or General Motors – and borrow money for 10 years at less than 2%

interest, and they're doing that; they're borrowing money, paying down old debt, buying back shares of their stock, and increasing dividends, which has helped pump up the stock market and helped pump up the financial sheets of these large corporations and banks.

But of course, as far as the little guy is concerned, their savings is being raided; they can't really get a mortgage. Anecdotally, I know three people in the last year, year and half, who have pretty good job histories and credit rankings, and they were turned down for loans. And I also know of three home sales of people in the last, I'd say, six to nine months, and all three were done through fully cash sales. And so the normal channels of people getting mortgages or businesspeople and entrepreneurs getting loans from banks, that's just not happening in any kind of normal sense. And it's because of this financial repression that banks don't want to lend money to small businesses at such low interest rates. And so almost everybody is being negatively affected by this financial repression.

WOODS: All right, let me jump in here with a question that I think will help clarify things in people's minds. We understand that the Federal Reserve cannot directly affect, let's say, the interest rate on your savings account. It doesn't have any influence over that. What it can affect is what you've been talking about: the rate at which – the federal funds rate, which involves lending between banks. But it's not immediately obvious why that rate would have any connection whatsoever with the rate I'm receiving on my savings account at the bank. What is the connection? How does affecting one affect the other?

THORNTON: Well, the Fed, at the federal funds market, lends money to the big banks. Currently I think it's right at .16th of 1%. And so that's the cost of their capital. And eventually, of course, in the federal funds market, where banks lend money to each other – so your hometown bank, in other words, can get money through this marketplace at a very low rate. And so if it has two choices – either borrowing the money through this Federal Reserve-influenced bank market, or getting the money from you – you have to compete with this market that's being flooded by the Federal Reserve. And so you can't really blame your own bank for giving you such a low interest rate, because they're in business to make money, as well. And so they go to the lowest cost provider of credit, and that currently is not people in their hometown, but rather it's this federal funds market that's influenced and directed and controlled by the Federal Reserve.

WOODS: What about the claim that this policy by the Fed of consistently low interest rates going on for really 15 years. Rates have been either low or been pushed lower, abnormally low, that this is necessary for economic health, that we need this; otherwise, investment will be choked off, and recession will come back. This is necessary for our economic health.

THORNTON: Oh, yeah, I mean the central bankers tell us that they're trying to stimulate the economy, that they're trying to create jobs, that they're trying to generate economic growth. But the truth is this is a schemed design to stealthily steal

from the productive class in order to enrich the unproductive financial class and the counterproductive political class. That's what I call a con game, because they're saying one thing, but doing another.

And of course, if we look at income distribution statistics in the United States, over those 15 years that you're talking about you see a massive leap up in economic inequality as this financial class is enriching itself on the actions of the central bank. And the rest of us are being left behind. And it's like, say for example, you were a bakery, and the government was providing you with free flour to make your breads and other baked goods; if you got free inputs into your production process, oh, obviously, you're going to make a lot of money outcompeting your fellow competitors. And that's what's going on here. And that's why – in fact, everybody is upset about this changing income distribution, where we have these mega-wealthy people at the top – - 1% and 10% of the income distribution chain. And the rest of us, where wage rates have been lagging behind, and real wage rates, which are adjusted for inflation, have actually been falling over that 15-year period.

So this is a stealthy war that's being waged by the bureaucrats at the central bank, the Federal Reserve, and the financial class, which is the major beneficiary. Now, it's not just Wall Street; it's the big banks, and it's the large corporations, and government itself that are the primary beneficiaries here. But that's a very small slice of the American pie.

WOODS: I want to talk about your section on negative interest rates. We talked a bit about this with Bob Murphy last week in Episode 417 – I'll link to that on today's show notes page. We talked about what Krugman had had to say about this; that this was an impossibility, and then it actually started to occur. What exactly is the scenario in which people would actually pay more than the face value for a bond? Why would they do that?

THORNTON: Yes, of course, we've been getting this question a lot, because negative interest rates just don't make sense in a free market economy. If you have a free market economy, you'd never have negative interest rates. But we don't have a free market economy, Tom.

So this 15-year period of money printing and financial repression, the end result has been negative interest rates on some two-year government bonds for some governments. And the idea that it would make sense is intuitively questionable. Why would you pay, say 1,050 Euros for a government bond that, two years from now, is only going to be worth 1,000 Euros. That just doesn't make any sense; you could just take the money out of the bank and hold the 1,050 Euros in your mattress.

But in today's economy, where you have very wealthy people and financial firms who want to store large amounts of money in a bank, the problem is that those customers don't necessarily trust the banks or for some kind of bailout on the part of governments, because governments have instituted bail-in provisions for the large, systemically risky banks.

WOODS: Yeah, now what is a "bail-in"?

THORNTON: Yeah, everybody needs to know this. A bail-in is sort of what happened in Cyprus, when they had their financial crisis. And what happens is that when a large, systemically risky bank is found to be bankrupt, instead of the taxpayers making the depositors good on their deposits, what happens is the depositors make the bank good by simply removing some of their deposits and wiping them off the board. So, for example, a bail-in provision might protect your FDIC-insured amount of your deposit, but everything above that you might lose it all; you might lose 50% of it, or it might be transferred into stock certificates in that bank.

But the key is is the depositors are going to lose money. And so people with tens or hundreds of millions of dollars in a bank, they don't want to accept that risk, because those are the ones that are going to be hurt most obviously by these bail-in provisions. So instead, they're willing to buy government bonds at negative interest rates or at a discount, let's say, because they feel that the government bonds are going to be backed by the taxpayer of that country, and they trust the government more than they trust the banks. And so neither one is completely trustworthy, but they feel that at least part of their money should be sheltered by buying government bonds.

The other possibility for some banks – and this is probably certainly true with Swiss bonds, Norwegian bonds, Finnish bonds, Germany – if you're using Euros and trying to store Euros in your bank account, you might be better off by buying Swiss government bonds, because if you're betting on the idea that the Swiss franc is going to appreciate and the Euro is going to depreciate, so even if you get negative interest rates on the Swiss government bond, you may be still better off in Euro terms, because the Swiss franc is expected to appreciate, let's say, and the Euro is expected to depreciate. So for those two reasons, we're seeing these negative interest rates in some of these European government bond markets.

WOODS: What's interesting to me in the midst of all this is the number of articles I'm seeing on the Left, talking about the imminent collapse of capitalist, and I guess Chris Hedges had an article, "Karl Marx Was Right." And you know, all right; I get that they're on the Left, and they have certain preconceptions in the way they look at the world, but, for heaven's sake, they really can't have any nuance whatsoever? They look at the banking sector in the U.S. and they think of this as capitalism? They really think that's a free market banking system, that what you're describing here is just the spontaneous result of human cooperation? And this is the main source of the confusion, that people think that what you have is a laissez-faire system, and it's yielding you these perverse results. But these perverse results are not coming from laissez-faire.

THORNTON: And that's why your show is so important, Tom: to get the word out and to straighten people out on what's really going on here. And I'm not saying capitalism is going to die off because of all this craziness, but it's at risk, and there are significant dangers because of this financial repression, and the world currency war that's going

on amongst central banks. And of course, Karl Marx was an advocate of central banks, and that's what's putting the world economy in such danger.

And of course, the banks, as you pointed out in your book, that the number of regulators that U.S. banks have to put up with and the different levels of regulation that they have to put up with, which has only been significantly increased since Dodd-Frank Act was passed. And now we have a phenomenon where banks, particularly the big banks, they actually have to set aside office space for regulators who are going to be there on a daily basis. So you're going to have a federal regulator or state regulator, who's probably a lawyer, telling you what to do on a daily basis. And any big decision that you're going to make, they have to approve it.

And I even know of one case where a large commercial bank, the Federal Reserve people on inspecting them and doing a physical inspection of their site, told the bank that they were going to have to build a bigger building, because they were going to need more office space, both for more internal control people, as well as government regulators being permanently housed inside the bank.

And so this is another aspect of financial repression, is that the government controls banks and their behavior down to the minute details, telling them what they can and cannot do. And also providing barriers to entry into banking, so they create sort of an oligarchy of banks that will get bailed out under every circumstances, and basically the federal regulators are telling them what they can and cannot do on the minute details of the banking business. So this is not capitalism in any respect, whatsoever. It might be Fascism, state socialism, but it's not capitalism in any sense of the word.

WOODS: You know, Mark, someday I should have somebody on – maybe you, maybe somebody else from the Mises Institute; I'll have to think it over – but someday I should have an episode on what banking ought to look like, what it would look like without all the interventions. And then we would have a real sense of just how deformed things are today.

And of course what you're describing here is the reason that, frankly, the election season is going to be so heavily misleading. Because we're going to get the impression that we've got these people with dramatically opposed ideas, who have clashing visions for the country, and we get to choose one. But it doesn't matter which vision winds up being victorious. Not one of them is going to change anything about what you just described. This is all completely off the table. There won't be any criticism of Federal Reserve policy, changes or – very, very minimal. And it doesn't matter which party winds up winning. And the parties tend to nominate the mainstream sorts of candidates, and those candidates are not going to touch anything here. And so it just goes on and on and on.

So that is the frustrating part, and that's why we need these brilliant flashes of light that we get from a Ron Paul who surprises everybody by running onto the scene, talking about the Fed, and generating interest in it. Well, we have to keep that

momentum going in order to make sure people understand what's really happening and they don't fall for Chris Hedges and the left-wing nonsense.

Well, Mark, thanks for being with us today. Show notes page will be TomWoods.com/422. We'll link to this article; we'll link to more about you, your books; we'll link to the Mises Institute, *Quarterly Journal of Austrian Economics*, where you're the book review editor. It'll be a great companion to this episode, TomWoods.com/422. Thanks again, Mark.

THORNTON: Thank you, Tom, I enjoyed it.