



The Fed and the 1%
Guest: Mark Thornton
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WOODS: You've got a piece coming out next week as a Mises Daily at Mises.org, and we're getting a sneak preview of it here. It's about Martin Wolf, who is a chief economics commentator at the *Financial Times*, a very, very important position, who is—well, you know what? I am not going to give away what it is that he's advocating. I want you to tell us without editorial comment first what it is that he thinks will lift the economies of the West out of the doldrums.

THORNTON: Well, his best solution that he thinks is most viable is if governments around the world went on a massive building campaign to build productive assets financed by huge government deficits. But he doesn't think governments have a taste for that, and so he's advocating a continuation for the foreseeable future of a cheap-money policy that we already have, basically, of zero interest rates and quantitative easing. He believes that we should just shut up about that and accept it because that's the second best solution available.

WOODS: Now I as the average observer might want to respond to Wolf with regard to his proposed large-scale building project with the counterexample of Japan, right? Isn't that obviously what comes to mind? The enormous trillions of yen that they have spent on building programs, on fiscal stimulus of this kind, and their economy didn't really have a whole lot to show for that.

THORNTON: Tom, it's a perfect example. They have been at this Keynesian policy response, or this Keynesian policy solution of massive public works projects financed by huge government deficits now for almost 25 years, and they have spent a huge proportion of their budget on these public works projects. Someone said that they've virtually covered the entire country of Japan in concrete of one form or another, and the only thing they have really established is one of the world's largest government deficits, which now exceeds 200 percent of GDP. Most economists pin the beyond the point of no return level at about 100 percent. So if your government debt is 100 percent of your GDP, you're considered teetering into a very bad economic path, and Japan has over 200 percent of government national debt versus their GDP.

So that proposal for reforming the economy, for stimulating the economy in the case of Japan, has proven just disastrous, and it could bring the Japanese economy down significantly going forward. But it's also true that these public works projects have never worked in any country that's tried them. It's just never panned out. We tried that here in the United States during the Great Depression, and yet the Great Depression continued on for many, many more years to come. So public works spending, deficit spending—these projects never stimulate an economy, and they are usually not really worth very much once they have been completed. You're just spending and wasting money.

WOODS: Well, of course, they are politically determined, so there's no profit and loss test. So they are going to be arbitrary to one degree or another. The way I always think of it is, you can spend some money on a building project, say for a bridge, but when that project is over, there is still no job for the bridge builder on the other side of that bridge. This is at best a temporary expedient. Bob Murphy has argued that in fact it actually makes things worse because it's siphoning off resources from elsewhere in the economy. They claim, the Keynesians, that since resources are idle, we can just engage in these sorts of building projects without any consequences, but not all resources are idle, and you are going to have to pull some resources away from other projects to get them into these, so there are all kinds of issues related to that. But Wolf doesn't seem to hold out much hope that this is going to happen anyway. So maybe we should focus more attention then on his second-best solution as, you said, which is the continuation of the low or zero interest rate and easy money policy.

Now as you indicated, Mark, that really has been the default position, certainly in the United States for well, I don't know, a number of years now, and the results have been fairly lackluster, but at the same time somebody like Wolf could say they have been lackluster, but at least you're not seeing Great Depression part two, and that's at least something.

THORNTON: Yes, well, he's a Keynesian, and he's afraid of deflation, and so he's not—he doesn't want to go that route, where the economy uses the price system to restore economic stability. He wants to stimulate the economy with easy money and government spending to keep everything where it is. When in fact, from the Austrian perspective, the economic bubble that proceeded the economic crisis really moved labor and capital out of the places where they were needed most and demanded by consumers, and so Austrians realized that in order to get the resources of capital and labor back in the right places, you have to allow the price system to do its work. And that involves deflation. And that's what Keynesians are deathly afraid of. But if you think about it, Tom, if we allow deflation, what's going to happen? Well, capital prices, stock prices, land prices—they are all going to fall significantly, and labor prices as unemployment builds up are going to fall significantly, but consumer goods tend not to fall that much. The demand for those consumer goods, the basic, you know, food, clothing, and shelter—the basic items that we buy in the store on a weekly basis, they tend to fall very, very slowly and not very much, and so if consumer goods prices are relatively stable, yet labor and capital prices are falling significantly, that provides the opportunity for entrepreneurs to put

that capital, and to put that labor back in a different combination, put it to work producing consumer goods for a profit. So the deflation that we see in economic prices involves the natural reluctance of entrepreneurs to buy inputs at the boom level prices, and so they sit on the sidelines, and they wait for those prices to fall until they get to the point where they can put the capital and labor back together, working together profitably. That's what the Keynesians are afraid of. They are afraid of that deflation, which is an effect of entrepreneurs' reluctance to operate on the boom-level prices.

WOODS: Mark, I think even some free-market people think that when you have easy money policy that the main drawback is price inflation that hurts the average person, but that's only one aspect of the story. And they might come back and say that in fact, price inflation as measured by the CPI, anyway, is not really all that great, so that's not worth worrying about. But you point out in this article that there are many other negative consequences for a number of institutions on which the middle class, in fact, the 99 percent so-called, rely—insurance, pensions, and retirement savings accounts, etc. These things are all hurt by easy money policies. Can you talk about that?

THORNTON: Sure, and this is what makes my blood boil about Mr. Wolf—he understands this, and he actually points this out in his editorial. He understands that an easy monetary policy hurts most people in society. Specifically, he points out that it hurts insurance, it hurts pensions, and it hurts households, and the only people that it benefits are the large corporations, the big banks, and government itself. And so it's just hard to imagine somebody advocating a policy that does that kind of thing and expects that to somehow heal the economy, but if we think about it, it makes perfect sense. Low interest rates are making it very hard, for example, for insurance companies to earn a rate of return on their investments that are going to be necessary to meet their policy obligations, and so insurance companies is just one example where they have had to go out and invest in riskier investments so that the return on those investments can keep up with their policy obligations. The same is true with pensions. Pensions have had to go out and invest in riskier assets to keep up with their pension obligations, and when you think about it, most people have insurance policies to protect their life, their home, their car, their health, their business, and most people have some kind of pension, whether it's a public pension or a private pension, or whether it's a retirement account that they've managed themselves, and so this is impacting everybody in society basically, and it's impacting us in a negative way because we're being forced into riskier investments that could go bankrupt themselves, and as a consequence this easy monetary policy is putting us all at risk.

WOODS: All right, but Mark, let me play devil's advocate. Couldn't I say, though, that in a genuine free market, let's say a complete Rothbardian free market, there of course wouldn't be any government debt at all. There would be no government. There would be no government bonds. There would be no Treasuries to buy. In that environment, then, these institutions would not have the safe haven of Treasuries to put their money in, in the first place. They

would have to go around assessing the relative risk, the continuum of risk across a variety of asset classes and investment projects, and they would have to take their chances according to their best estimates as to what's going to give them the best return versus the amount of risk that they are taking on. So the fact that easy money policy means that they are not getting as good of a return on their investment in U.S. Treasuries, well, okay, but U.S. Treasuries are a non-market institution to begin with. So by in effect taking away this option from them aren't we kind of restoring the free market?

THORNTON: (laughs) Well, not exactly. The lower interest rate by the Fed reducing the interest rate on government securities also has the same effect on all marketplaces.

WOODS: That's what I wanted you to develop, okay, go ahead.

THORNTON: Yeah, so corporate bonds, the yield on corporate bonds has fallen to near all-time lows, and the yield on junk bonds has come down significantly as well, so even if you're investing in junk bonds, you're only earning about 6 percent interest, and with the default rate on junk bonds, particularly if the economy gets worse or the stock market goes down, you could end up with significant losses on those investments.

WOODS: So what's the causal relationship here? Why should the federal government's easy money policy—I can see what it would do to Treasuries, but how does it affect these other types of investments?

THORNTON: Well, when you go take your money into the investment markets, and you look at, for example, savings accounts, certificates of deposit, money market mutual funds, things that used to yield a real return, they are yielding less than one percent, and you have to pay taxes on that, and you also are subject to losing purchasing power due to inflation, and so you are actually losing purchasing power by putting your money in those assets. So many, many more people are putting them in things like—first of all, they went to corporate bonds, and as people piled money in there, the yield on corporate bonds falls. Recent corporate bonds by major corporations, and your corporate bonds are yielding only about two percent, and so they have gone up the risk ladder into junk bonds, and as more money is piled into junk bonds, the yield on those junk bonds declines, and so basically what the Fed has done by making these safe investments unattractive with such low yields is it's forced everybody to put money in riskier markets and particularly into the stock market, and so retirees have been investing in dividend-yielding stocks, and those dividend-yielding stocks therefore go way up in price. So the Fed has in fact inflated a stock market bubble and a bond bubble through these policies. The net effect of all these easy monetary policies has not been able to get us out of the economic quagmire, but it has created economic bubbles in the stock market, the bond market, land prices, and many other things.

WOODS: You say in your article the winners from easy money policies are the government, non-financial corporations, and large banks in the United States. Now, it may be obvious, for

example, why the government benefits from this. Maybe all these things are obvious, but it couldn't hurt to spell it all out.

THORNTON: Right, and that's based on a study that Wolf cites himself from the International Monetary Fund, and this is true not just in the United States but in other countries as well. Inflation, low interest rate policy, of course, helps borrowers. They get to borrow money at about 1 percent rather than 5 percent. The government is one of the biggest borrowers, and so its policy makes it cheaper for government to sell its debt and inflation, reducing the purchasing power of the dollar over time, means the government can pay back that debt with depreciated dollars. The same is true for large corporations. They can borrow money cheaply just like government, and they can hope to pay it off with depreciated dollars later on. So the borrowers are helped by low interest rate policy in both ways. They can borrow cheaply, and they can hope to pay it off in greatly depreciated dollars down the road. So it's a great deal for them, and of course, for banks. That's their raw material. It's like the federal government is subsidizing the raw material for banks. The banks can borrow the money from the Fed and relend it out into the economy at a very large spread between their cost and what consumers and entrepreneurs have to pay the banks to get that money. It'd be like the government subsidizing flour for bakeries. It just makes everything easier and more profitable, and we've seen the stocks of banks, particularly big banks, increase dramatically through this economic crisis.

WOODS: Let me read a couple of quick passages from your article. "The idea that easy money policies can cause economic bubbles and that those bubbles will lead to sustainable increases in investment, consumer spending, and increased aggregate demand is fallacious. Harming the workers and savers of society to benefit the ruling class is no way to get the economy back on track. Modern monetary policy is a scam of gigantic global proportions. Achieving economic recovery and growth requires first knowing what caused the problem in the first place, and a lack of aggregate demand is the effect, not the cause. A lack of aggregate demand is the crisis, not the cause of it. The cause of the crisis is easy money policy and runaway government spending and debt," and then you go onto say, "Continuing that is just going to intensify the problem." Toward the end you give us what the solution would be. Now, just come right out and tell us. I don't care about the political feasibility of it. That's of no interest to me. I want to know: if we could do the right thing, what would the right thing be?

THORNTON: Well, it's very basic, and this could be done mostly on an immediate basis, and the first one is for central banks to have no monetary policy at all, to have no interference with interest rates, and the Fed could essentially do that with the drop of a hat. It could do that instantaneously and allow market to take over, interest rates to rise, and for the economy to normalize, for savers to get a return and so on. The second thing is that the government should balance its own budget and reduce it over time. So the government should balance its budget without tax increases, and that budget should be reduced over time as quickly as possible. The third thing is to eliminate regulations, subsidies, and taxes on the economy. Eliminating just a

small number of regulators can result in a huge increase in the number of jobs throughout the economy and increasing GDP by tremendous amounts. So every regulator we have in the federal government pulls back the economy. Subsidies and taxes do the same thing. We should also transfer resources from the government to the economy; all the kinds of land that the government owns, labor, and capital should be transferred from the public sector to the private sector. The federal government has like 54,000 buildings that are unoccupied and could be used by the private sector. And also, of course, we should either eliminate or begin to eliminate all programs that burden future generations, because young people these days are looking out and they are seeing this tremendous national debt, the problems of Social Security, and they are very discouraged. A number of my students have considered or have actually moved out of the country because they don't think the United States is the land of the free and the future of prosperity.

WOODS: Mark, I can't help asking before I let you go if you might tell us something about this debate that you're preparing for at Oxford on the subject of drug legalization. What are the circumstances? Is there a group over there that invited you? Is it a team debate? Who is in it? When is it going to be, and will we be able to see a video of it?

THORNTON: Well, it's the Oxford Union debate. It's one of the oldest competitive debating societies in the world—Ronald Reagan, Margaret Thatcher, the Dalai Lama, Mother Theresa have all participated in debates at the Oxford Union. So I am thrilled to do it. I think now is the time to put an end to the War on Drugs. I don't know exactly the parameters of how many people we'll be debating or who my opposition is, but I feel very confident that I could win the debate. I think the case against the War on Drugs is not only obvious, but it's become increasingly understood by more and more people that the War on Drugs is not just costly, but it's actually counterproductive. The debate will be held in the first week of June, and it will be available to watch and listen to shortly thereafter on YouTube. I'm very excited about it, and I think it's a very encouraging sign that organizations like this have started to look at it seriously in terms of not just manipulating the War on Drugs in one way or another but in terms of eliminating it entirely and taking the law enforcement approach and the military approach to the problems of drug abuse off the table.