

The Frame of Mind of American Policymakers, Part 1

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I seldom become depressed, but when I consider that prosperity is created by “peace, easy taxes and a tolerable administration of justice” **I really think that the U.S. and other Western governments are doing their very best to impoverish their countries.**

A friend of mine, Michael Berry, whose missives I always read, could not have phrased this better than in “Importance of the Individual”, a recent report in which he quotes Milton Friedman (whose views I fully share in this particular instance) in an interview with Phil Donohue

According to Berry, “On February 11, 1979 Milton Friedman took 2-1/2 minutes to explain the critical importance of the individual and choice in the free enterprise system to a doubting Phil Donohue. **I wonder what Dr. Friedman would say 30 years later about our current predicament and the role government is assuming in our lives?** The individual’s freedom and ability to choose and take risks to create value are, of course, all important life elements and a cornerstone of our country.

“Individual ability to choose and take risk is being suppressed. It is increasingly evident that it is the government that is defining risk and the taking of risk. The sanctity of Moral Hazard has now been repeatedly breached by both recent administrations. We must guard these life elements jealously. Please take time to ponder the Friedman interview.

“Unfortunately in the current partisan atmosphere in Washington the role of the individual and that of individual risk taking is being suppressed. When the President of the United States uses the ‘Bully Pulpit’ to criticize institutions for not ‘playing ball’ (Chrysler debt holders) and forces a CEO to resign (GM’s Wagoner), when a Treasury Secretary and Chairman of the President’s Economic Council team up to run an auto company (General Motors), and when no institution is too large to fail (the other side of individual risk taking) something is seriously amiss. **Under the guise of saving the economy, there is a not so stealthy encroachment on the rights of the individual. No one is noticing.**

“This is not, ‘Change We Can Believe In.’ It is ‘change we must be wary of.’ Where is Milton Friedman when we really need him? Think carefully about the following interview which was conducted 30 years ago. Another read of Friedman’s ‘Free to Choose’ is in order for all. We pray that Washington will not stray too far.”

Phil Donohue: *When you see around the globe the mal distribution of wealth, the desperate plight of millions of people in underdeveloped countries. When you see so few haves and so many have-nots. When you see the greed and*

the concentration of power. Did you ever have a moment of doubt about capitalism? And whether greed is a good idea to run on?

Milton Friedman: *Well first of all tell me, is there some society you know that doesn't run on greed? You think Russia doesn't run on greed? You think China doesn't run on greed? What is greed? Of course none of us are greedy. It's only the other fella that's greedy. The world runs on individuals pursuing their separate interests. The greatest achievements of civilization have not come from government bureaus. Einstein didn't construct his theory under order from a bureaucrat. Henry Ford didn't revolutionize the automobile industry that way. In the only cases in which the masses have escaped from the kind of grinding poverty that you are talking about, the only cases in recorded history are where they have had capitalism and largely free trade. If you want to know where the masses are worst off, it's exactly in the kind of societies that depart from that.*

So that the record of history is absolutely crystal clear, there is no alternative way, so far discovered, of improving the lot of the ordinary people that can hold a candle to the productive activities that are unleashed by a free enterprise system.

Phil Donohue: *Seems to reward not virtue as much as the ability to manipulate the system.*

Milton Friedman: *And what does reward virtue? You think the Communist commissar rewards virtue? You think a Hitler rewards virtue? Do you think... American presidents reward virtue? Do they choose their appointees on the basis of the virtue of the people appointed or on the basis of political clout? Is it really true that political self-interest is nobler somehow than economic self-interest? You know I think you are taking a lot of things for granted. And just tell me where in the world you find these angels that are going to organize society for us? Well, I don't even trust you to do that.*

Well, for sure you won't find any angels at central banks around the world and in the economics faculties of universities. I needed quite a stiff drink after reading a *Wall Street Journal* article by Harvard Professor Gregory Mankiw, who advocates creating negative real interest rates through inflation and seems to have great sympathy for the outright expropriation of savers. Professor Mankiw needs no introduction. His great intellect was revealed on February 1, 2000, dead ahead of the NASDAQ collapse, when he expressed the view in the *Wall Street Journal* that "when you look at the mistakes of the 1920s and 1930s, they were clearly amateurish. It is hard to imagine that happening again – we understand the business cycle much better."

The mindset of the US Federal Reserve and of a very large number of economists is perfectly reflected in the views of Mankiw, according to whom, "It May be Time for the Fed to Go Negative" (see *Wall Street Journal* of April 19, 2009). For the ease of the reader I have added some comments, which will be noted in italics and with a 'MF'.

Mankiw: *With unemployment rising and the financial system in shambles, it's hard not to feel negative about the economy right now. The answer to our problems, however, could well be more negativity. But I'm not talking about attitude. I'm talking about numbers [MF: He means negative interest rates]... What is the best way for an economy to escape a recession? Until recently, most economists relied on monetary policy. Recessions result from an insufficient demand for goods and services – and so, the thinking goes, our central bank can remedy this deficiency by cutting interest rates. Lower interest rates encourage households and businesses to borrow and spend. More spending means more demand for goods and services, which leads to greater employment for workers to meet that demand.*

There is no clear evidence that interest rate cuts stimulate lasting employment gains, because “lower interest rates encourage households and businesses to borrow and spend.” If an industry is plagued by overcapacities (the oil and mining industry in the 1980s and 1990s), lower interest rates (interest rates fell throughout the 1980s and 1990s) are irrelevant. (The same applies for autos now.) In addition, interest rate cuts that encourage households to borrow and spend may not help employment in the country that implements such policies (the US after 2001) but instead in another country (China), where production costs are lower and where a large pool of savings is available for capital spending. (Also, it is not consumption that creates prosperity but capital formation.) To his credit, Mankiw recognizes this problem. He writes:

Mankiw: *The problem today, it seems, is that the Federal Reserve has done just about as much interest rate cutting as it can. Its target for the federal funds rate is about zero, so it has turned to other tools, such as buying longer-term debt securities, to get the economy going again. But the efficacy of those tools is uncertain, and there are risks associated with them...*

So why shouldn't the Fed just keep cutting interest rates? Why not lower the target interest rate to, say, negative 3%? At that interest rate, you could borrow and spend \$100 and repay \$97 next year. This opportunity would surely generate more borrowing and aggregate demand.

The problem with negative interest rates, however, is quickly apparent: nobody would lend on those terms. Rather than giving your money to a borrower who promises a negative return, it would be better to stick the cash in your mattress. Because holding money promises a return of exactly zero, lenders cannot offer less. Unless, that is, we figure out a way to make holding money less attractive.

At one of my recent Harvard seminars, a graduate student proposed a clever scheme to do exactly that. Imagine that the Fed were to announce that, a year from today, it would pick a digit from zero to 9 out of a hat. All currency with a serial number ending in that digit would no longer be legal tender. Suddenly, the expected return to holding currency would become negative 10%. That move would free the Fed to cut interest rates below zero.

People would be delighted to lend money at negative 3%, since losing 3% is better than losing 10%. Of course, some people might decide that at those rates, they would rather spend the money – for example, by buying a new car. But because expanding aggregate demand is precisely the goal of the interest rate cut, such an incentive isn't a flaw – it's a benefit. [MF: I think that most people would choose to invest in another country where savings wouldn't lose 3% per year.]

The idea of making money earn a negative return is not entirely new. In the late 19th century, the German economist Silvio Gesell argued for a tax on holding money. He was concerned that during times of financial stress, people hoard money rather than lend it. John Maynard Keynes approvingly cited the idea of a carrying tax on money. With banks now holding substantial excess reserves, Gesell's concern about cash hoarding suddenly seems very modern.

Silvio Gesell (1862–1930) was a rather obscure economist, but a cult formed around his more outlandish socialist and land nationalization ideas. He was the author of *Die Reformation des Münzwesens als Brücke zum Sozialen Staat* (*The Reformation of the Monetary System as a Bridge to a Social State* – read “socialism”).

In fact, I had forgotten about him until Mankiw brought him up, but I remember well how my history teacher in high school – who also had a socialist tick, but was an outstanding historian – discussed him at length in the context of socialism and land reforms through expropriation. (Right throughout the course of history, this has never worked. Also, Gesell's tax on cash had more to do with soaking the rich than stimulating consumption.)

In 1919, Gesell was called to take part in the Bavarian Soviet Republic by Ernest Niekisch. The Republic offered him a seat on the Socialisation Commission and later appointed him as the People's Representative for Finances. Fortunately (for the world), his term of office lasted only seven days. After the bloody end of the Soviet Republic, Gesell was held in detention for several months and was later acquitted of treason. Unfortunately, he never had the opportunity to read George Orwell's *Animal Farm* – published in 1945 – which refuted most of his arguments for a “social state”.

The Frame of Mind of American Policymakers, Part 2

In his 1,200 page *History of Economic Analysis*, Joseph Schumpeter mentions Gesell just twice and just en passant – in one instance when explaining that Keynes himself acknowledged in the *General Theory of Employment, Interest and Money* that Gesell had a much larger influence on him than Hobson. (Keynes called Gesell a “non-Marxian socialist”.)

Keynes noted in the General Theory that, according to Gesell's proposal, "currency notes (though it would clearly need to apply as well to some forms of at least bank-money) would only retain their value by being stamped each month, like an insurance card, with stamps purchased at a post office. The cost of the stamps could, of course, be fixed at any appropriate figure. According to my theory it should be roughly equal to the excess of the money-rate of interest (apart from the stamps) over the marginal efficiency of capital corresponding to a rate of new investment compatible with full employment." And although Keynes found "the idea behind stamped money sound", he nevertheless conceded that there would be difficulties in the implementation of this scheme:

But there are many difficulties which Gesell did not face. In particular, he was unaware that money was not unique in having a liquidity-premium attached to it but differed only in degree from many other articles, deriving its importance from having a greater liquidity-premium than any other article. Thus if currency notes were to be deprived of their liquidity-premium by the stamping system, a long series of substitutes would step into their shoes – bank-money, debts at call, foreign money, jewelry and the precious metals generally, and so forth...there have been times when it was the craving for the ownership of land, independently of its yield, which served to keep up the rate of interest; though under Gesell's system this possibility would have been eliminated by land nationalisation. (John Maynard Keynes, General Theory, London, 1936, Chapter 23)

I briefly discussed Gesell's ideas because his books would make excellent bedtime reading for Comrade Obama. **I doubt, however, that the Commissar can indulge in much reading time since he has embarked on micro-managing the economy.** Also, as Keynes himself admitted, there are enormous problems associated with the "stamping system", as well as with the "hat system" explained above by Mankiw, because savers would turn to other forms of "money" such as precious metals, non-ferrous metals, diamonds, paintings, stamps, cigarettes (see also below), metal coins, ecstasy pills, cocaine, prepaid cards, etc. But back to Mankiw!

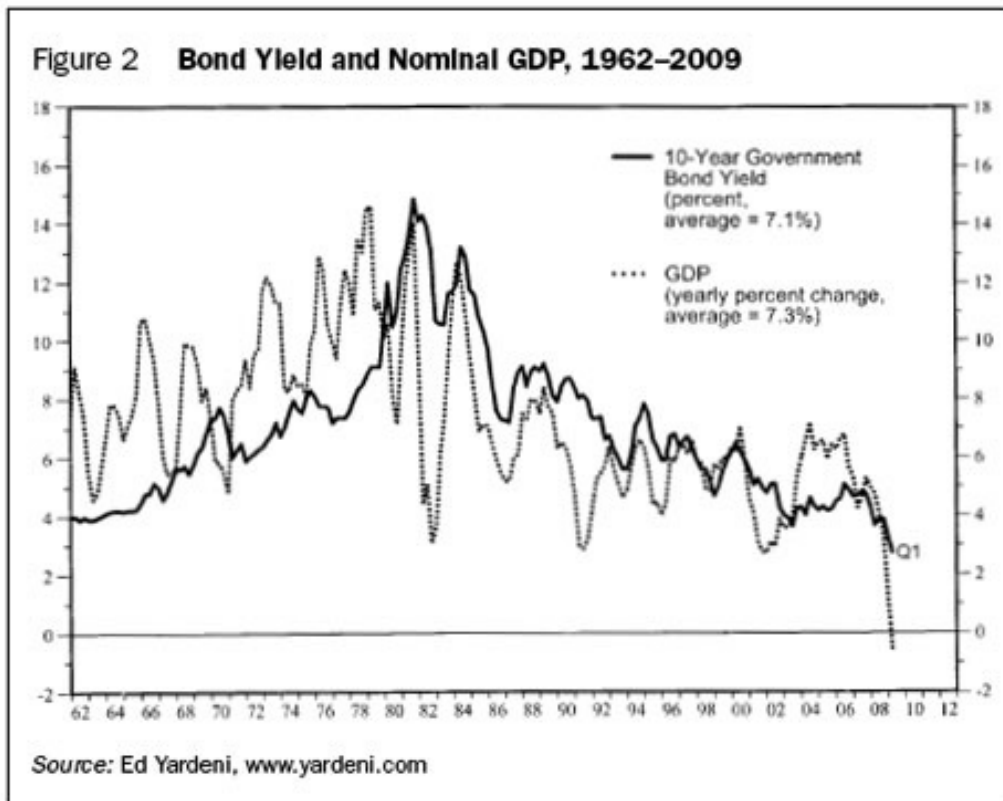
Mankiw: *If all of this seems too outlandish, there is a more prosaic way of obtaining negative interest rates: through inflation. Suppose that, looking ahead, the Fed commits itself to producing significant inflation. In this case, while nominal interest rates could remain at zero, real interest rates – interest rates measured in purchasing power – could become negative. If people were confident that they could repay their zero-interest loans in devalued dollars, they would have significant incentive to borrow and spend...*

Yes, real interest rates could be strongly negative, as was the case in the 1970s, which generated high inflation and high nominal GDP growth rates but a collapse in bond prices (see Figures 1 and 2). **Currently, Mr. Mugabe maintains in Zimbabwe by far the lowest interest rates in the world in real terms. But who is lending him money?** What about capital spending and consumption in Zimbabwe? Go and look for yourself, Professor Mankiw! But there is no need to travel that far. After all, it is far too uncomfortable for

an academic at Harvard. Closer to home – in the US – there is sufficient evidence that consumption as a percentage of the economy fell in the inflationary environment of the late 1960s and 1970s when interest rates in real terms were mostly negative.

Mankiw: Ben S. Bernanke, Fed chairman, is the perfect person to make this commitment to higher inflation. **[MF: I am in full agreement on this point.]** Mr. Bernanke has long been an advocate of inflation targeting. In the past, advocates of inflation targeting have stressed the need to keep inflation from getting out of hand. But in the current environment, the goal could be to produce enough inflation to ensure that the real interest rate is sufficiently negative...





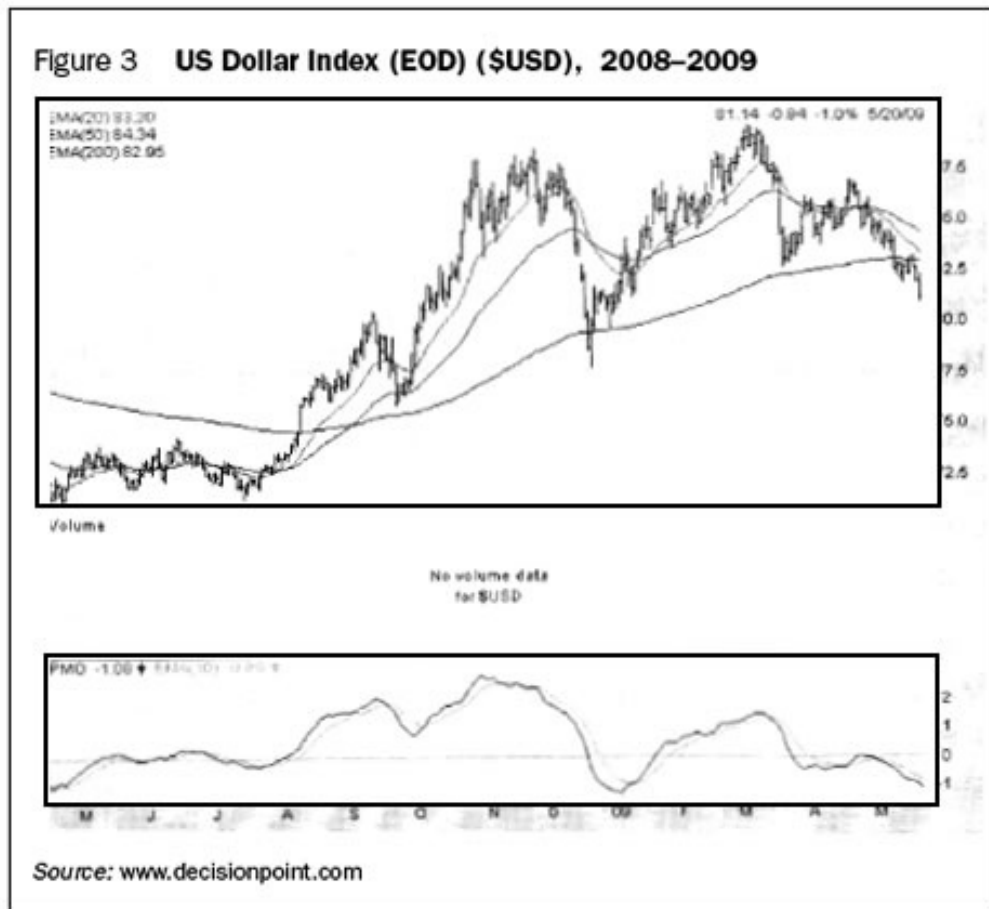
I have a far simpler solution for creating inflation (for which I should obtain a Nobel prize in economics) than the half-baked measures proposed by Gesell, Mankiw, and his students, in order to create “more demand for goods and services, which leads to greater employment for workers to meet that demand”. **The government could issue to each US man, woman, and child free vouchers for different goods and services, which would have a three or six months’ expiry date.**

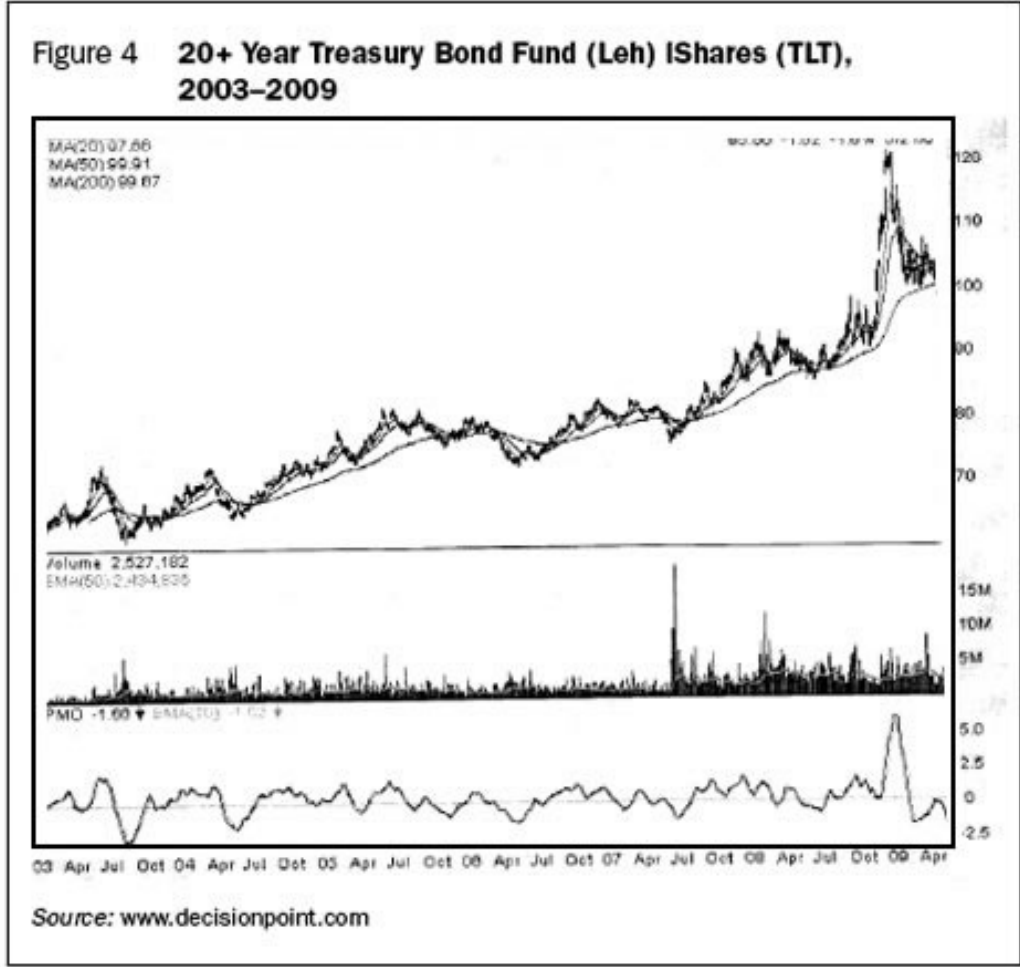
There are 310 million Americans. The government could issue 310 million vouchers to be exchanged for a new car, 100 million vouchers to be exchanged for a \$500,000 home, a billion vouchers for a visit to an amusement park, a trillion vouchers each for Prozac and attendance at a sporting event, and so on. **AIG and Citigroup would be in charge of making a market in these vouchers, so if someone didn’t wish to buy a car he could exchange the car voucher for cigarette vouchers or any other voucher.** But since these vouchers would have an expiry date they would unleash a huge consumption boom, which would temporarily lift the prices of everything and, therefore, achieve the objective of the US economic policymakers of creating inflation and negative real interest rates. (An even simpler solution would be to remove all taxes for two years, or simply to send each American a cheque for a million dollars, but the impact on spending would not be as powerful as with my voucher system.)

With my voucher system, the current interventionist government could even target the bailout of some specific industries that are currently

ailing. For instance, it could issue 310 million vouchers, each of which could be exchanged for the purchase of a new car; whereas it would not issue vouchers for goods where demand remains strong – namely, for guns, cocaine, ecstasy, prostitutes, and porno magazines. And if some protectionist flavour was desired – since this would really stimulate domestic capital spending and employment – the government could issue a disproportionately larger quantity of vouchers for the purchase of domestic goods than for foreign goods.

And who would pay for the vouchers that businesses would receive from consumers? Nobody! The Treasury Department could issue bills, notes, and bonds to pay businesses for the tendered vouchers, and have the Fed buy them all. But would nobody really pay for my voucher system? The objective of my voucher system would be fulfilled, which is to create inflation, but at the cost of a tumbling US dollar and collapsing bond prices, as was the case in the 1970s (see Figures 3 and 4).

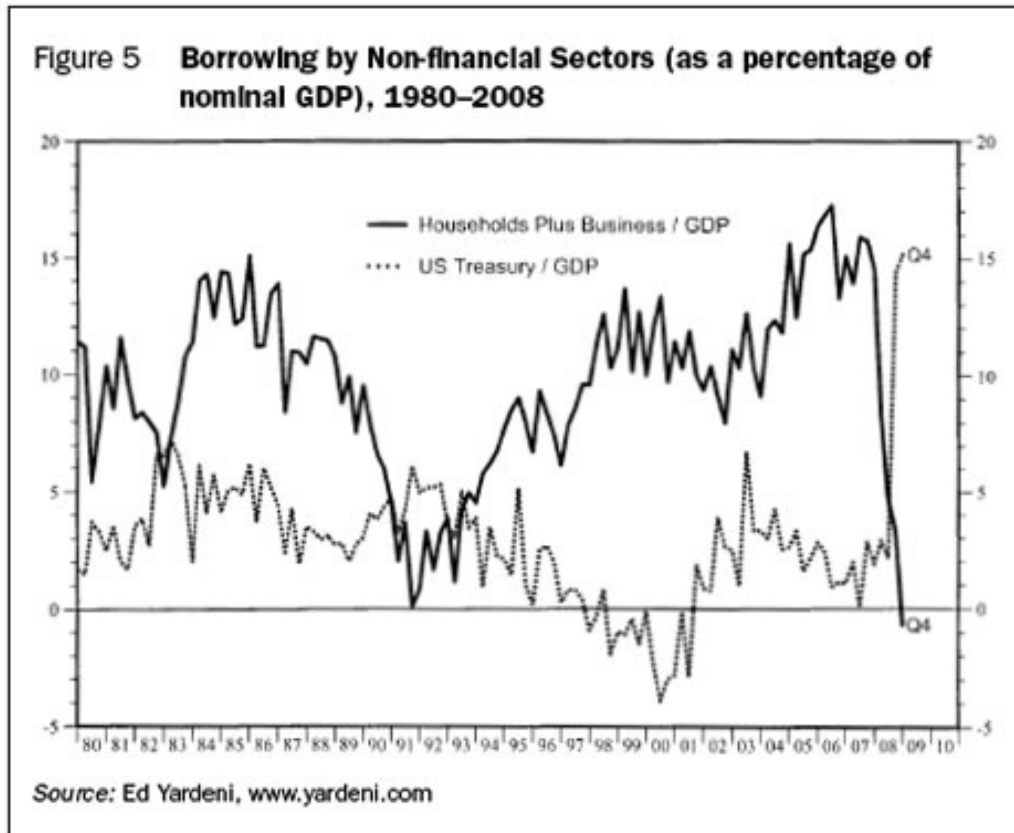




I may add that a collapsing dollar might lead to a “little too much inflation”—even for the Bernankes and Mankiws of this world! The astute reader will naturally ask what will happen when the economic stimulus arising from the vouchers ends, since they are issued with an expiry date. The answer is very simple: the same thing as occurred after 2007 **when the stimulus from easy monetary policies and strong debt growth (inflation) ended: demand collapsed.**

But that should be of no great concern to the Mankiws of this world. The government could then issue new vouchers with a higher face value and in higher quantities. So, whereas my initial voucher program would have issued 310 million car vouchers with a face value of \$40,000 each, the government could now issue 400 million car vouchers with a face value of \$100,000 each. Now, some of my readers may think that I have lost my mind, but macroeconomically there is very little difference between my voucher program, which guarantees to stimulate demand and bring about inflation immediately, and the way the Treasury has recently expanded the fiscal deficit and the Fed has increased its balance sheet (see Figure 5). My vouchers stimulus runs out when the vouchers expire, and the Treasury’s and the Fed’s stimuli run out when these esteemed institutions stop increasing

them! But my point is that if a government is determined to create inflation and negative real interest rates, there is really nothing standing in the way of its doing so.



Naturally, both voucher and money stimuli lead to enormous economic and financial volatility. In this respect, I urge my readers to read R.A. Radford's "The Economic Organisation of a P.O.W. Camp", in Paul A. Samuelson, John R. Coleman, and Felicity Skidmore (eds), *Readings in Economics* (McGraw-Hill, 1952). (For those people who have little time to read, this is a superb book about economics and contains brief contributions by economists such as Malthus, Marshall, Boehm-Bawerk, Taylor, Hayek, Tobin, Friedman, Samuelson, Schumpeter, Ricardo, Bastiat, Rostow, Kuznets, Burns, Eckstein, Keynes, and Kindleberger, and many more.)

Radford describes how in a prisoner's camp during the Second World War cigarettes became the principal "currency" and how prices compared to cigarettes fluctuated widely. The Red Cross would make weekly deliveries of cigarettes to the P.O.W. camp and prices would subsequently fluctuate largely as a function of the quantity of cigarettes delivered. **When plenty of cigarettes were delivered the prices of other goods would increase; conversely, when the supply of cigarettes was scarce, prices would deflate.** Radford concluded that "the economic organisation described was both elaborate and smooth-working in the summer of 1944. Then came the August cuts [in the delivery of cigarettes by the Red Cross – ed. note] and

deflation. Prices fell, rallied with deliveries of cigarette parcels in September and December, and fell again. In January 1945, supplies of Red Cross cigarettes ran out and prices slumped still further: in February the supplies of food parcels [to a lesser extent, food also was used as medium of exchange – ed. note] were exhausted and the depression became a blizzard. Food, itself scarce, was almost given away in order to meet the non-monetary demand for cigarettes.”

Radford never won a Nobel prize for his observations about the economics of a P.O.W. camp, but they taught me far more about relative and absolute price movements than did economists at Ivy League schools. When supplies of cigarettes (money) increased relative to food items, prices for food rose more than for cigarettes; and when supplies of cigarettes fell, food prices fell more than prices of cigarettes. In other words, the successful P.O.W. camp hedge fund traders had to constantly adjust their investment position between cigarettes (money) and food (assets), depending on their relative supplies. This is the investment environment I expect for the foreseeable future.

Source: [The Daily Reckoning \(Part 1 & Part 2\)](#), June 10 & 11, 2009.