

OUR ENEMY, THE FED

FACT AND FICTION ABOUT THE
FEDERAL RESERVE AND THE
U.S. ECONOMY



TOM WOODS

NOTE TO THE READER

This eBook discusses the Federal Reserve System and its effects on the U.S. economy. For the sake of simplicity it does not describe the technical aspects of the Fed, including the precise manner in which the Fed increases the money supply. Hence the reader will not encounter reference in these pages to open-market operations, the federal-funds rate, or other terms of that kind. For these mechanical questions the reader is referred to *The Mystery of Banking* or *The Case Against the Fed*, both by Murray N. Rothbard.

OUR ENEMY, THE FED

As recently as 2006, the Federal Reserve System (or the “Fed”) was exactly where it prefers to be: quietly engaged in its policy decisions regarding interest rates and money creation, and off the table for political discussion. Most Americans had no idea what it did or even what it was, and politicians never said a word about it. Anyone who did mention it was probably a crank, who really ought to have more confidence in the wise management of the experts.

Most Americans still have no idea what the Fed is, but popular awareness of, and opposition to, the Fed is now at its highest level in American history. Thanks to the financial crisis, the work of Ron Paul, and the ability of the Internet to circumvent the gatekeepers of approved opinion, a small but determined anti-Fed constituency has developed among people who understand that the Fed, supposedly the source of economic stability, is giving us instability. This alleged guardian of the dollar has actually been lowering the dollar’s value. And this institution, supposedly a great bulwark of capitalism, is in fact a central-planning agency at odds with the basic principles of a free market.

Commentators with high media profiles have helped to pour fuel on this growing anti-Fed fire. Peter Schiff, bestselling author and president of Euro Pacific Capital, may be the best known of these. Schiff foretold the crisis, including the bankruptcy of Fannie Mae and Freddie Mac. His books *Crash Proof*, *The Little Book of Bull Moves in Bear Markets*, and *How an Economy Grows and Why It Crashes*, all of which have sold well, take an Austrian approach to ten years. Jim Rogers, founder of the Rogers International Commodity Index and co-founder of the Quantum Fund in 1970 – which saw its

portfolio gain 4,200 percent over the following ten years – is another such critic. There are many others.

The Federal Reserve System, the American central bank, enjoys a government-granted monopoly on the creation of legal-tender money. It has been given the task of manipulating the money supply in such a way as to maximize employment and output and minimize price inflation. It is designed to give the United States a “flexible” currency, which in practice means a currency that can be inflated in order to suit the needs of government and financial institutions. Fed chairmen have boasted of their institution’s ability to foresee and prevent economic crises, and to mitigate those that do occur. For a long time, people accepted claims like these.

These days, more and more people are less and less sure about them.

Since the Fed opened its doors in 1914 following the passage of the Federal Reserve Act in December 1913, the dollar has lost more than 95 percent of its value, after having held its value intact from the beginning of the republic until the creation of the Fed. Most of this debasement of the dollar has taken place since 1971, when the last vestiges of the gold standard were removed and the central bank could inflate the money supply with much greater abandon.

When people raise questions about the utility of the Fed, they are usually lectured about how volatile the economy used to be and how much better it is now, thanks to the wise oversight of our central bank. But recent research has thrown cold water on this claim. Christina Romer finds that the numbers and dating used by the National Bureau of Economic Research (NBER, the largest economics research organization in the United States, founded in 1920) exaggerate both the number and the length of economic downturns prior to the creation of the Fed. In so doing, the NBER likewise overestimates the Fed’s contribution to economic stability. Recessions were in fact not more frequent in the pre-Fed than the post-Fed period.¹ (Romer chaired the Council of Economic Advisers under Barack Obama, so she isn’t exactly a

free-market ideologue.)

But let's be real sports about it, and compare only the post-World War II period to the pre-Fed period, thereby excluding the Great Depression from the Fed's record. (The Great Depression, we all know, was just practice!)² In that case, we do find economic contractions to be somewhat more frequent in the period before the Fed, but as economist George Selgin explains, "They were also almost three months shorter on average, and no more severe."³ Recoveries were also faster in the pre-Fed period, with the average time peak to bottom taking only 7.7 months as opposed to the 10.6 months of the post-World War II period. Extending our pre-Fed period to include 1796 to 1915, economist Joseph Davis finds *no appreciable difference between the length and duration of recessions as compared to the period of the Fed.*⁴

But perhaps the Fed has helped to stabilize real output (the total amount of goods and services an economy produces in a given period of time, adjusted to remove the effects of inflation), thereby decreasing economic volatility. Not so. Some recent research finds the two periods (pre- and post-Fed) to be approximately equal in volatility, and some finds the post-Fed period in fact to be more volatile, once faulty data are corrected for. The ups and downs in output that did exist before the creation of the Fed were not attributable to the lack of a central bank. Output volatility before the Fed was caused almost entirely by supply shocks that tend to affect an agricultural society (harvest failures and such), while output volatility after the Fed is to a much greater extent the fault of the monetary system.⁵

When we look back at the nineteenth century, we discover that the monetary and banking instability that existed then were not caused by the absence of a government-established agency issuing unbacked paper money. According to Richard Timberlake, a well-known economist and historian of American monetary and banking history, "As monetary histories confirm... most of the monetary turbulence — bank panics and suspensions in the nineteenth century — resulted from excessive issues of legal-tender paper money, and they were abated by the working gold standards of the times."⁶ In a nut-

shell, we are faced once again with the faults of interventionism being blamed on the free market. Here we'll look at just two illustrative examples.

The Panic of 1819 was the result of years of artificial credit creation by the banks, including the newly chartered Second Bank of the United States, established in 1817.⁷ That is to say, the banks issued far more paper money than they had gold to back it in their vaults. As often happens when the country is flooded with money created out of thin air, speculation of all kinds grew intense, as eyewitness testimony abundantly records. The country was on a sugar high, based not on real savings but on mere paper.

During the years when the United States had no central bank (the period from 1811, when the charter of the first Bank of the United States expired, and 1817), government had granted private banks the privilege of expanding credit while refusing to pay depositors demanding their funds. In other words, when people came to demand their money from the banks, the banks were allowed to tell them they didn't have the money and that depositors would simply have to wait a couple years – and at the same time, the bank was allowed to continue in operation. By early 1817 the Madison administration finally required the banks to meet depositor demands, but at the same time chartered the Second Bank of the United States, which would itself be inflationary. The Bank subsequently presided over an inflationary boom, which came to grief in 1819.⁸

The lesson of that sorry episode – namely, that the economy gets taken on a wild and unhealthy ride when the money supply is dramatically and artificially increased and then suddenly reduced – was so obvious that even the political class managed to figure it out. Numerous American statesmen were confirmed in their hard-money views by the Panic. Thomas Jefferson asked a friend in the Virginia legislature to introduce his “Plan for Reducing the Circulating Medium,” which the Sage of Monticello had drawn up in response to the Panic. The plan sought to withdraw all paper money in excess of specie over a five-year period, then redeem the rest in specie and have precious-metal coins circulate exclusively from that moment on. Jefferson and John Ad-

ams were especially fond of Destutt de Tracy's hard-money *Treatise on the Will* (1815), with Adams calling it the best book on economics ever written (its chapter on money, said Adams, defends "the sentiments that I have entertained all my lifetime") and Jefferson writing the preface to the English-language edition.⁹

While the Panic of 1819 confirmed some political figures in the hard-money views they already held, it also converted others to that position. Condé Raguet had been an outspoken inflationist until 1819. After observing the distortions and instability caused by paper-money inflation, he promptly embraced hard money, and went on to write *A Treatise on Currency and Banking* (1839), one of the great money and banking treatises of the nineteenth century. Davy Crockett, future president William Henry Harrison, and John Quincy Adams (at least at that time) were likewise opposed to inflationist banks; in contrast to the inflationary Second Bank of the United States, Adams cited the hard-money Bank of Amsterdam as a model to emulate. Daniel Raymond, disciple of Alexander Hamilton and author of the first treatise on economics published in America (*Thoughts on Political Economy*, 1820), expressly broke with Hamilton in advocating a hard-money, 100 percent specie-backed currency.¹⁰

For a long time, the Panic of 1873 was said to have inaugurated the so-called Long Depression, which lasted until 1879 in the more sober accounts, and until 1896 in the more outlandish ones. However, the modern consensus is that there was in fact no "Long Depression" after all. Even the *New York Times*, which admits nothing, admits this:

Recent detailed reconstructions of nineteenth-century data by economic historians show that there was no 1870s depression: aside from a short recession in 1873, in fact, the decade saw possibly the fastest sustained growth in American history. Employment grew strongly, faster than the rate of immigration; consumption of food and other goods rose across the board. On a per capita basis, almost all output measures were up spectacularly. By the

end of the decade, people were better housed, better clothed and lived on bigger farms. Department stores were popping up even in medium-sized cities. America was transforming into the world's first mass consumer society.

Farmers, moreover, who panicked at falling prices for agricultural commodities, at first failed to note that other prices were falling still faster. The terms of trade for American farmers improved considerably during the 1870s.¹¹

As for historians, they seem to have been fooled by the statistics on consumer prices, which fell an average of 3.8 percent per year. And since the conventional wisdom says that consistently falling prices will cause the earth to break free of its axis and go tumbling toward the sun, they concluded that this must have been a time of terrible depression. With the gold standard restored in 1879 after being abandoned during the Civil War, the 1880s were likewise a period of great prosperity, with real wages rising by 20 percent.

The argument that the U.S. economy was susceptible to panics without the wise custodianship of a central bank can also be dismantled another way. In the nineteenth century, nearly all American states instituted a regulation known as unit banking, which limited all banks to a single office. No branch banking was allowed, whether intrastate or interstate. The obvious result was a very fragile and undiversified banking system in which banks could be brought to ruin if local conditions turned sour.

The banking panics that struck the United States between the Civil War and World War I occurred either during the spring planting season or the fall harvest, and were closely connected to the cycle of cotton production. That is no coincidence. Those are the times when bank lending (and leverage) is at its peak, and thus the banks are most vulnerable to shifts in depositor confidence and the likelihood of withdrawals by risk-averse depositors.¹² In other words, with bank capital constant but the amount of loans increasing, bank leverage by definition grows, and those depositors most concerned about the riskiness

of their bank's activities are at that moment most likely to take their money out, thereby making the bank's condition more fragile. The Fed supplied banks with a source of liquidity during moments of temporary but intense depositor pressure like these.

So is the Fed therefore the great savior? Only if we forget two things. First, other countries, which had not crippled their banking systems with unit banking laws, had been safe from these panics all along. Canada, which had fractional-reserve banking like the United States but no unit banking laws, avoided all the financial turmoil of American bank panics, and without the help of a central bank — the Bank of Canada was not established until 1934. As Milton Friedman was fond of pointing out, although the Great Depression claimed over 9,000 American banks, the number of banks that failed in Canada at that time was *zero*. American bank panics, it turns out, were in large part the result of government intervention — in the form of unit banking — in the first place.

Imagine that: less regulation, more stability.

Second, it is by no means clear that the Fed was particularly successful in stopping bank panics, a phenomenon that came to an end only with the advent of deposit insurance in 1934. Andrew Jalil of the University of California, Berkeley, concluded in a 2009 study that “contrary to the conventional wisdom, there is no evidence of a decline in the frequency of panics during the first fifteen years of the existence of the Federal Reserve.”¹³ Elmus Wicker, in *Banking Panics of the Gilded Age* (2000), observes that “there were no more than three major banking panics between 1873 and 1907 [inclusive], and two incipient banking panics in 1884 and 1890. Twelve years elapsed between the panic of 1861 and the panic of 1873, twenty years between the panics of 1873 and 1893, and fourteen years between 1893 and 1907: three banking panics in half a century! And in only one of the three, 1893, did the number of bank suspensions match those of the Great Depression.” By contrast, there were five separate bank panics in the first three years of the Great Depression alone.¹⁴

Even during these pre-Fed panics the bank failure rate was small, as were the losses depositors suffered. Depositor losses amounted to only 0.1 percent of GDP during the Panic of 1893, which was the worst of them all with respect to bank failures and depositor losses. By contrast, in just the past thirty years of the central bank era, the world has seen twenty banking crises that led to depositor losses in excess of 10 percent of GDP. Half of those saw losses in excess of 20 percent of GDP.¹⁵

Contrary to popular belief, the age of central banking has not in fact given us a world with fewer banking crises, if we define a crisis as a wave of bank failures associated with large losses. Between 1874 and 1913, we count four such crises: Argentina (1890), Australia (1893), Italy (1893), and Norway (1900). (Interestingly enough, each of these countries experienced a boom and bust in real estate, which had been subsidized by these governments in ways meant to evade market discipline.) Between 1978 and 2008, on the other hand, there were 140 banking crises, twenty of which were worse than the two worst (Argentina and Australia) from the earlier period.¹⁶

Just as important as revising the history of the Fed in light of sounder data and research is increased scrutiny of what the Fed is doing in the present. The Federal Reserve has been criticized for bringing about ever-higher prices, for instance. (Inflation is the increase in the supply of money; higher prices, which are themselves sometimes called inflation, are merely the effects of inflation.) An artificial increase in the supply of money tends to push prices higher than they would have moved otherwise. When we read criticisms of inflation, they're usually confined to the problems faced by people on fixed incomes when prices rise. If someone's income consists of an invariable one thousand dollars per month, for example, and the prices of the goods he buys double, the purchasing power of his income is cut in half.

But the problems of inflation go much deeper than this. For one thing, inflation has unjust redistribution (or Cantillon) effects. The process whereby government or its privileged central bank creates money inevitably enriches politically well-connected groups at the expense of everyone else. When the

Fed creates new money out of thin air, that new money is not distributed in equal proportions to all Americans. A helicopter does not fly over the country, evenly distributing the new money among the people. To the contrary, the new money enters the economy at discrete points. Whoever receives it first gets to spend it before it has circulated throughout the economy and raised prices. The windfall the privileged enjoy comes at the direct expense of average people, who lack the political connections to be among the first in line to receive the newly created money. Those people pay the higher prices that the new money brings about before that new money reaches them. And who gets the new money first? Banks, businesses with government contracts, investment banks that sell government bonds to the Federal Reserve, and the like. The reader will detect a pattern here.

All known cases of hyperinflation, which is sometimes defined as a 50 percent or higher rise in the price level per month, have occurred under a system of paper money. The devastating consequences of hyperinflation are not just economic, as the frugal and provident watch the value of their savings vanish into thin air. Its consequences are social, political, cultural, and even spiritual. Inflation at any level has these kinds of effects. Saving and thrift seem less desirable when money is going to lose value over time; it makes more sense to spend right now while its value is at its height. Old-fashioned moral advice about thrift and provision for the future seems stupid and backward to an inflationary generation.

Governments that hold a monopoly on the issuance of money have had a bad habit of debasing and destroying that money, a habit whose ill effects have been all the greater as governments have moved away from precious-metal money and into paper money whose value they can more readily manipulate. From 1066 to the early seventeenth century, the English silver pound was debased by one third, for a depreciation factor of 0.3. Over the next 200 years, with the rise of modern banking, the supply increased by a factor of sixteen. In just the thirty years from 1973 to 2003, the U.S. money supply (M1) increased by a factor of five. Naturally, with a record like this,

prices have fluctuated considerably, especially compared with the relative stability of prices under the gold standard of the nineteenth century. “A study of about 30 currencies,” writes Swiss economist Peter Bernholz, “shows that there has not been a single case of a currency freely manipulated by its government or central bank since 1700 that enjoyed price stability for at least 30 years running.”¹⁷

The very existence of a monopoly producer of legal-tender paper money fosters moral hazard. There is no physical limitation on the creation of additional paper money, as there would be on the creation of additional gold. Virtually no scarce resources are necessary. For that reason, major market actors know there is no physical constraint on bailing them out in emergencies. The only obstacle — easily conquered, as we know all too well — is one of political will.

Fiat money likewise bestows on government far more power than it would otherwise enjoy. Government can now raise money for itself in the inconspicuous way of creating it out of thin air. It can get away with siphoning resources from the citizenry without having to raise taxes or borrow so much that it drives up interest rates for private borrowers. Both of these means of raising revenue attract public ire. In political calculations, it appears far better to tax the people by the surreptitious means of not allowing prices to fall, as they would naturally, and in fact causing them to rise, thereby reducing the people’s standard of living. Hardly anyone will understand this process, and most people can be made to believe that greedy businessmen and price gougers are the source of their woes.

Fiat money artificially and unjustly increases the wealth and economic power of the banking system, well beyond what would occur in the free market. Ordinary individuals earn money by providing some good or service, and then take that money into the market to acquire the goods and services they themselves wish to have. Creating money out of thin air, on the other hand, allows the money creator to enter the market and seize the goods or services he wants without having first supplied anything himself. As one monetary

economist has written:

The market economy can be understood as a great organism that caters to the needs of consumers as expressed in money payments. When the economy is flooded with legal-tender fractional-reserve notes, the whole economic body of society begins to cater excessively to the needs of those who control the banking industry. The American economist Frank Fetter once observed that the unhampered market economy resembled a grassroots democratic process: one penny, one market vote. From this point of view the imposition of fractional-reserve notes through legal-tender laws creates market votes out of nothing. The bankers and their clients (usually the government in the first place) have many more votes than they would have had in a free society.¹⁸

While others are enriched, the average person has to struggle to save. With his money losing value every year, he would be ruined if he saved for the future by piling up paper dollars. Under a precious-metal money, people could save for the future by simply acquiring gold and silver coins. (Investing that money could yield them still higher returns, but they always retained this more conservative option.) Back when they circulated as money, they held or increased their value over time. Today, on the other hand, just to hold on to the purchasing power of their savings, to say nothing of increasing it, people have to become speculators, navigating their way through the financial markets as best they can. If the stock market should tumble, there goes their retirement.

Even this does not exhaust the arguments against irredeemable paper money. Artificial money creation by a central bank can also influence the business cycle, which we'll discuss in greater detail below. Business calculation is undermined when what looks like profits can turn out to be nothing more than a general rise in prices. Then there is the moral argument that no system of fiat money has ever emerged voluntarily; it is always imposed by means of the state's apparatus of compulsion.

Still, supporters of government fiat money insist on the beneficial aspects of inflation. We need inflation, we're told, because a growing economy can function only if the supply of money increases along with it. This is a fallacy. Any supply of money can facilitate any number of transactions. If the supply of goods and services should double, we do not need — and it would be positively disruptive — to double the supply of money along with it. Prices simply fall by half, and the same supply of money can purchase the entire supply of goods.

Until the early twentieth century, in fact, peacetime prices fell consistently throughout American history. This will come as a surprise to most Americans, who, having grown accustomed to seeing consumer prices rise over time, have thoughtlessly if understandably assumed that this must be how the economy works. But it isn't. Under hard money the supply of money grows relatively slowly, and the supply of other goods and services increases more rapidly. With these goods and services more abundant with respect to money, their prices fall.

Today we're told that this would be a terrible situation. Just terrible. Because if consumer prices fell, and were expected to continue falling, no one would ever buy anything. We'd all be sitting back waiting for prices to fall even more. Only on our deathbeds, presumably, as we were taking in our last breaths, would we frantically grasp an iPod, a paperback, and a new leather jacket, since for us there would at last be no more tomorrow on which prices could fall still more.

We wouldn't need to spend any time refuting this crazy theory if it weren't constantly repeated by our talking heads, whose job it is to warn us of the unthinkable scenarios that would arise were we not carefully supervised by our self-sacrificing public servants. It is true that people prefer lower prices to higher ones, but it is also true that they value goods in the present more highly than they do the same goods in the future. This factor offsets the desire to wait indefinitely for a lower price. A candy bar today is more serviceable to a consumer than is a candy bar available only two, ten, or four hundred years

from now, even if the candy bar will be cheaper then. Sane people do not refuse to purchase a one-dollar cup of coffee just because they expect the price to fall to 95 cents three years from now. The prices of personal computers have steadily fallen while their quality has steadily risen. Have we all stoically awaited still further declines in price, or have a few of us broken down and actually purchased a computer?

Then we're told that falling prices must threaten business profitability and even lead to mass bankruptcies. How can business firms survive if the selling prices of their goods suddenly fall?¹⁹

If the deflation is anticipated, there is no problem. (It is, after all, the role of the entrepreneur to anticipate the prices at which he can profitably sell his products in the future.) Businesses remain just as profitable as they would have been had prices risen or remained constant (as long as they had anticipated those outcomes as well). If business firms expect prices to fall by the time they bring their goods to market, they will be willing to pay less in the present for all the inputs, or factors of production (resources employed to produce goods and services), they need to produce their goods. If a general fall in prices is expected, suppliers of these factors of production will have no choice but to accept these lower bids for their goods and services, since no one will be able to afford to continue buying inputs from them at the old, higher price level while remaining profitable. In this way, an expected fall in consumer prices is factored in to the prices business firms pay for the goods they use as inputs, thereby maintaining profitability for these firms even in the face of falling prices.

Thus a widget company may pay \$10 in inputs for every widget it produces, and be able to sell each of these widgets to the public at \$15. Suppose prices begin to fall, and widgets are expected to sell at only \$9 (instead of \$15) by the time they are ready to be brought to market next year. The widget manufacturer can now afford to continue producing widgets if he can acquire his inputs for, say, \$6 instead of the previous \$10. If he can do so, then he will still make a profit even in this deflationary environment. There will still be a

positive spread between his sales revenues and his costs. But if, as is the case in a general deflation, all prices are falling, suppliers will have no choice but to cut prices (which they can indeed do, since their own costs will be falling given the general fall in prices).²⁰ Production will continue profitably as before.

What if the deflation is *unanticipated*? In that case, some firms will find themselves unable to sell their product at a price that will bring them an adequate return, and they may even suffer losses (because the prices they can fetch for their products, thanks to the deflation, are lower than they expected them to be). In effect, they find that they had paid too much for the factors of production to leave them with a profit, in light of the lower prices they can now charge for their products. For that reason, the result of unanticipated deflation for a given firm could very well be bankruptcy. The firm would then wind up in bankruptcy court, where reorganization of the firm or the sale and distribution of its assets to its creditors in order of seniority takes place.

Now if the assets are sold off, they are merely shifted from one production process to another but continue in use. If the firm continues in operation but under new ownership, as the firm's creditors take the reins, its previous production process likewise continues as before. So while bankruptcy is most unfortunate for a particular firm, *it is of no significance to the economy in the aggregate*. It does not matter to economic activity who the particular owners of firms happen to be. If ownership changes hands from one group of people to another as the result of bankruptcy proceedings, this does not matter from the point of view of the economy as a whole. From the economy's perspective, nothing has changed. Production continues as before.

As we shall see below, central bank inflation that pumps money into the banking system and pushes interest rates down gives rise to an artificial economic boom that distorts the structure of production and encourages the creation or expansion of sectors of the economy that will have to contract or close down when the inevitable bust comes along. These kinds of inflation-fueled distortions do not occur in a deflationary environment. The worst that

could happen from the point of view of production is a series of hiccups, minor and temporary interruptions, while bankruptcy courts sort out questions of ownership and compensation.

Critics will reply that deflation is indeed a terrible fate to be avoided because firms loaded with debt will find those debts harder to pay back — a \$1 million loan contracted five years ago is more difficult to repay today if the dollar is now worth more (and is thus now harder to come by), just as a debt is *easier* to pay if the dollar has *lost* value during the period of the loan. But for one thing, banks could simply renegotiate the debt in light of the money's increased purchasing power. And even if banks insisted on payment of the debt in the agreed-upon number of nominal dollars, we are faced merely with the problem of bankruptcy — again, a problem for an individual firm, but not a problem for the economy at large. Once again, new owners take over, and production continues as before.

And who says heavy debt and high leverage are the best means for financing a business firm? Why should these means be artificially encouraged? Perhaps it would be better, especially in light of the private debt levels of recent years, to have a system that encourages firms to finance themselves with equity rather than more and more debt.

Finally, we might note that deflation, contrary to what we often hear, has not in fact been associated with economic depression in history. According to a 2004 study in the *American Economic Review*, which examined data from around the world, “The data suggest that deflation is not closely related to depressions. A broad historical look finds more periods of deflation with reasonable growth than with depression, and many more periods of depression with inflation than with deflation. *Overall, the data show virtually no link between deflation and depression.*”²¹

To be sure, there is much more that both sides can say about deflation, but this simple analysis should be enough to make the reader suspect that a fall in prices may not be the end of the world after all. But if that's true, then

why all the hysteria about deflation, hysteria we never hear with respect to inflation?

Think about who suffers most during deflation. One victim is the government — which, always deeply in debt in the modern era, has a much harder time servicing that debt when it has to repay debt-holders with more valuable dollars than it borrowed. Another is the array of financial firms on Wall Street that have arranged their debt-based investment strategies in the Fed-inspired expectation of ongoing price inflation. When these firms suddenly find they need to repay short-term debt in more valuable dollars than they borrowed, their debt-fueled house of cards comes crashing down.

Note that some of the most powerful and influential forces in society — those that benefit most from cheap money, and who get the newly created money before anyone else — are the ones most hurt by deflation. Everyone else benefits from falling prices and therefore higher real incomes. More to the point, those people who suffered from the inflation — not just those on fixed incomes but also the general run of the population — and who wound up paying higher prices for everything they bought, now benefit from the increase in the dollar's value and the fall in prices. (Economist Joseph Salerno suggests the term *rabbatage* to refer to this reversal of fortunes that occurs during deflation.)²²

Thus it is little wonder that we hear nothing but hysteria about deflation, which hurts the political and economic establishment the most, and only the mildest concern about inflation, which hurts everyone else. If I were the head of a highly leveraged firm and worried about my firm's ability to service its debt, or if I headed the Federal Reserve System, which consistently inflates away the dollar's purchasing power and gives the country higher prices than we would otherwise have faced, I too would want to portray deflation as an unthinkable disaster from which ongoing doses of inflation are meant to protect you. But deflation is not an economic problem, as we have seen. It is a political problem, in that those parties that expect to be hurt by it seek to use the machinery of government and central banking to prevent it or at least

mitigate its effects.

Now it's true that a massive unanticipated deflation would cause widespread and undesirable disruption for a lot of business owners, though as we've seen it need not interfere with overall production to any significant extent. But if this is your concern, then hard money becomes all the more desirable. Because the process of gold and silver mining is so time consuming, and thus increases in gold and silver coming on to the market are telegraphed well into the future, it is far easier to anticipate the future movement of the money supply under gold or silver than it is to anticipate how much money a central bank chairman might choose to create or destroy. More importantly, the supply of gold and silver isn't going anywhere. It is not subject to sudden drops the way paper money is. All the gold and silver that have ever been mined are still available somewhere on the earth's surface. The supply of paper money, precisely because it can be created at will and in any amount out of thin air, fluctuates wildly in supply when compared to the relatively stable supply of gold and silver. Sudden crashes involving massive drops in the supply of money do not occur in a hard-money system.

Fashionable opinion is of course horrified at and dismissive of the gold standard. It's stupid, it's backward, it's not sophisticated like our money-printing system of today, etc. If figures of prominence ridicule it enough, average people will assume it must be a foolish idea and think no more about it. Economist Ludwig von Mises cut through the propaganda to explain the virtues of the gold standard, virtues which account for why supporters of power oppose it with such vigor:

The eminence of the gold standard consists in the fact that it makes the determination of the monetary unit's purchasing power independent of the measures of governments. It wrests from the hands of the "economic tsars" their most redoubtable instrument. It makes it impossible for them to inflate. This is why the gold standard is furiously attacked by all those who expect that they will be benefited by bounties from the seemingly inexhaustible

government purse.

What is needed first of all is to force the rulers to spend only what, by virtue of duly promulgated laws, they have collected as taxes.... No back door must be left open where inflation can slip in. No emergency can justify a return to inflation. Inflation can provide neither the weapons a nation needs to defend its independence nor the capital goods required for any project. It does not cure unsatisfactory conditions. It merely helps the rulers whose policies brought about the catastrophe to exculpate themselves.

One of the goals of the reform suggested [a return to sound money, a system in which governments cannot create money at will] is to explode and to kill forever the superstitious belief that governments and banks have the power to make the nation or individual citizens richer, out of nothing and without making anybody poorer. The shortsighted observer sees only the things the government has accomplished by spending the newly created money. He does not see the things the nonperformance of which provided the means for the government's success. He fails to realize that inflation does not create additional goods but merely shifts wealth and income from some groups of people to others.²³

This is not a side issue that we can safely neglect, that we might focus instead on matters that might be considered more fashionable or politically viable. Economist F. A. Hayek warned about this excessive concern with political feasibility. If this is a group's overriding concern, it will never influence public opinion. It will simply be steamrolled by events.

What we lack is...a program which seems neither a mere defense of things as they are nor a diluted kind of socialism, but a truly liberal radicalism which does not spare the susceptibilities of the mighty...which is not too severely practical, and which does not confine itself to what appears today as politically possible.

We need intellectual leaders who are willing to work for an ideal, however small may be the prospects of its early realization. They must be men who are willing to stick to principles and to fight for their full realization, however remote.

Those who have concerned themselves exclusively with what seemed practicable in the existing state of opinion have constantly found that even this had rapidly become politically impossible as the result of changes in a public opinion which they have done nothing to guide.²⁴

Issues become politically viable precisely because they are discussed rather than evaded. That is the proper reply to those timid “free-market” economists who supported various aspects of the Wall Street bailouts on the grounds that a particular measure was the best of the “politically viable” options. Perhaps other options would have been politically viable if cowardly economists had helped to shape the debate by telling the truth, defending the free market, and letting the chips fall where they may, instead of meekly acquiescing in mainstream opinion.

To his credit, Rush Limbaugh tried years ago to devote one of his programs to the critical subjects of money and credit, subjects Americans need to understand cold if we are to have any hope of reversing the terrific mess our government and central bank have caused. Rush doesn’t have the right answers, but at least he was asking the right questions, which is more than can be said for most radio hosts. Unfortunately, he was promptly flooded with listener emails urging him to drop that subject and talk instead about Caroline Kennedy’s intentions to run for U.S. Senate, an issue of zero importance.²⁵

The government and its privileged central bank are not the indispensable supports of our monetary system. They are, as Mises said, interlopers. They give us discoordination and chaos. They enrich the favored few at the expense of the many. They make possible an expansion of government power that would have been unthinkable in earlier times.

The Federal Reserve is truly the elephant in the living room. We are supposed to pretend it isn't there. Fewer and fewer people are playing this game any longer. They have pulled back the curtain and taken a good, hard look at the Fed and its central planning mandate. No wonder Thomas Cooley urged the Fed in May 2009 that it needed to become "boring" again: all its unprecedented activities were attracting attention to it.²⁶ The peons are not to worry their pretty little heads about what goes on at the Fed.

It is not just that the Fed has been a failure according to the unreasonably exacting standards of its incorrigible critics, as its supporters allege. As we have seen in this eBook, the Fed has been a failure on its own terms. It has not in fact delivered what it promised. Old data that its supporters once pointed to in triumph have been shown in recent years to be hopelessly flawed. People who claim the Fed has been a fantastic success are bluffing, or do not know what they are talking about. The emperor truly has no clothes.

We need neither a monopolistic, government-issued paper money, nor indeed a government-imposed gold standard (although that would be a significant improvement). If ever there were anything government cannot be trusted to monopolize, it is money, as Hayek concluded four years after winning the Nobel Prize in economics.²⁷ As I wrote in *Meltdown*, we either believe in the free market or we do not. The market has no need of, and is positively harmed by, an anomalous planning agency in the realm of money and interest rates. Contracts, private property, and voluntary human relations are as capable of providing money as they are any other economic good.

The ray of hope in all this is that for the first time in nearly a century, the Fed is routinely subjected to close scrutiny, with more and more Americans informing themselves about its history and its activities. More Americans than ever are reading the work of economists like Murray Rothbard (1926-1995), whose books *The Case Against the Fed* and *What Has Government Done to Our Money?* are available to read online for free. Until the Internet increased the average person's access to information, those who highlighted objections to the Fed could be ignored or derided as cranks. But

as people have begun to listen to and read the economists of the Austrian School, they have found thinkers who are not cranks. They have found just about the only people who make any sense. It is the alleged experts who have begun to sound like the cranks.

This newfound interest in the Fed couldn't have come at a better time. All the otherwise welcome talk about rolling back government power and spending will come to naught unless the Fed, the elephant in the living room, is confronted squarely. Many critics of the federal government say we should just get back to the Constitution. Yet waving a piece of paper in Washington's face will do nothing as long as the money creation machine established in 1913 continues to churn away.

The main reason the Fed has come under increased scrutiny in recent years was the financial crisis and the housing bust of 2007 and 2008. Had the Fed not repeatedly intervened to push interest rates down, the market would have stopped the housing bubble in its tracks. Faced with a vastly increased demand for mortgage loans, banks would have found their supply of loanable funds rapidly depleted. Interest rates would have shot up as a result, and further speculation in real estate would have been arrested right then and there. These high interest rates would also have encouraged people to save, and those increased savings would have provided the genuine wherewithal for any further home lending to take place.

Asset bubbles, which involve goods whose prices are unsustainably high for long periods of time, should always make us suspect monetary mismanagement. When demand for a particular asset (such as a house) rises, this increased demand pushes its price above the level it would otherwise have reached. Yet in a bubble, people keep buying the asset even though its price goes on rising, *without a contraction in other sectors of the economy*. So if the money to pay for this increasingly expensive asset isn't coming from lower expenditures on other goods, where is it coming from?

That is where the Fed's monetary spigot comes in. When the Fed floods

the banks with money, the purchase of assets of ever-increasing price becomes possible.²⁸ Looking back on the dot-com boom of the late 1990's, the *Economist* concluded: "Without easy credit the stock market bubble could not have been sustained for so long, nor would its bursting have had such serious consequences. And unless central bankers learn their lesson, it will happen again."²⁹

So where can people turn for common sense? In the wake of the financial crisis that began to unfold in 2007 and 2008, some Americans began looking for answers in unconventional places – since all the conventional places had been completely blindsided by what occurred. In particular, a tradition of thought known as the Austrian School of economics has enjoyed an explosion in popularity and interest since 2008. Millions of people have watched a YouTube video called "Peter Schiff Was Right," which collected television segments of Euro Pacific Capital president and financial commentator Peter Schiff predicting in 2006 exactly what wound up happening to the U.S. economy, with other commentators dismissing or even laughing at him. (The original version of that video is no longer available, but versions with lesser view counts can be found on YouTube.) Schiff is an Austrian School economist. Another 6.5 million people watched "Fear the Boom and Bust," a rap video that depicts John Maynard Keynes and Austrian School economist and Nobel Prize winner F. A. Hayek explaining their differing views of what causes economic booms and busts. My own book *Meltdown* (2009), which provided an Austrian account of what had happened to the U.S. economy, became the *New York Times* bestseller.

Normally the debate at a time like this would have taken place between (1) people who thought government needed to borrow lots of money and spend it and (2) people who thought the Fed needed to create a lot of money and spend it. *That* would have been the permitted range of the conversation. Anyone who doubted that America's economic problems could be solved by kicking the can down the road with more borrowing, spending, and money creation would have been out of luck. But the Austrians, whose writings and

speeches have been critical of both fiscal and monetary stimulus, refuse to play by these rules. Neither form of stimulus, in the Austrian view, gets to the heart of what's wrong with the economy, and both can only prolong the agony. The Austrian School, the oldest continuously existing school of economic thought, and probably still among the smallest, is, as a result, now the fastest growing.

Paul Krugman, the Keynesian economist who has pushed for even greater “stimulus” measures than have been undertaken so far, has been frustrated by how many people are “asking how we got into this mess rather than telling us how to get out of it.”³⁰ But for the Austrians – and anyone with any common sense – this has to be the central question. They are asking it not to annoy Paul Krugman, but because only if the genesis of the crisis is understood can we know if the promised cures might actually be worse than the disease.

When the Austrian economist F. A. Hayek won the Nobel Prize in economics in 1974, it was his work in business-cycle theory four decades earlier that was being honored. And it's that theory that has been attracting the most attention from a curious public today. What is it that makes the economy move in a boom-bust pattern, such that we're doing great for a while and then in the toilet for a while, and then great again? That's what business-cycle theory seeks to explain.

To understand the Austrian theory, consider two scenarios.

Scenario 1. Consider what happens when the public saves more money. Since banks now have more funds to lend (namely, these saved funds deposited by the public), the rate of interest they charge on loans will fall. These lower interest rates stimulate an expansion in long-term investment projects, which are more interest-rate sensitive than short-term projects. Thanks to compound interest, considerably more money in interest payments is paid over the life of a long-term than a short-term project, so a downward move in interest rates will make long-term projects seem disproportionately attrac-

tive.

(A brief digression: Austrians speak of a “structure of production.” In that structure, lower-order stages of production are those stages closest to finished consumer goods: retail stores, services, and the like. Wholesale and marketing are stages of higher order than these. Mining, construction, and research and development are of still higher order, since they are so remote from the finished good that reaches the consumer.)

The other side of the coin when the public *increases its saving* is that *it is consuming less*. When people’s consumption spending falls, this is when it makes most sense for higher-order stages of production to expand. What with people’s additional *saving*, there is relatively less demand for *consumer goods*, and the resulting contraction of lower-order stages of production will release resources for use in the higher-order stages.

In other words, if people are saving more and thus buying fewer hats or decks of playing cards right now, the hat and playing-card industries will need fewer trucks, less gasoline, fewer employees, and so on. The goods and employees released by consumer-goods industries like these are now available to make possible the completion of the high-order projects that the low interest rates have made more attractive to entrepreneurs. The contraction of the lower-order stages thereby makes possible the expansion of the higher-order stages. An employee who answered the phones at the playing-card factory, for example, can now get a job filing work orders for a contractor as construction (a higher-order stage) increases.

In short, when interest rates are free to fluctuate, they coordinate production across time and ensure that the configuration of the production structure is sustainable. *Long-term production is begun only when sufficient saved resources are available to fund it.*

Scenario 2. Government-established central banks like the Fed in the U.S. have various means at their disposal to force interest rates lower *even without any corresponding increase in saving by the public*. (For more on the

precise way in which the Fed accomplishes this, see Murray N. Rothbard's *The Mystery of Banking*, or his shorter *What Has Government Done to Our Money?*) Just as in the case in which public saving has increased, the lower interest rates spur expansion in high-order stages of production.

The difference, though, is a critical one, and it guarantees that these *artificially* low interest rates will not yield the happy outcome in Scenario 1. In this case, people have not decreased their consumption spending. If anything, the low interest rates on loans encourage further consumption. If consumption spending is not constricted, the lower-order stages of production do not contract. *And if they do not contract, they do not release resources for use in the higher-order stages of production.*

Consequently, the economy is inadvertently arranged in an unsustainable configuration. The public does not want this ratio of higher-order to lower-order production. Not enough resources exist to fund both the lower-order production the public wants *and* the wave of higher-order projects the economy has been misled into initiating. Instead of harmonious economic development, there will ensue a tug-of-war between the higher and lower stages of production. The prices of the resources employed by the lower-order stages (labor, trucking services, etc.), which is what the public actually wants, will be bid up as the various firms and industries in those stages compete for them. These higher input prices, in turn, threaten the profitability of the higher-order projects, which were begun without the expectation of this increase in costs.

What all this means is that the economy-wide discoordination that reveals itself in the bust is not caused by the “free market.” To the contrary, it is *intervention* into the free market, in the form of distortions of the structure of interest rates — which are crucial coordinating mechanisms — that causes the problem. Production projects that are interest-rate sensitive are given artificial and unhealthy stimulation that eventually reverses itself in losses and bankruptcies.

As the boom turns into bust, the economy tries to readjust itself into a configuration that conforms to consumer preferences. That is why it is so essential for government to stay entirely out of the adjustment process, because arbitrary government behavior can only delay this necessary and healthy process. Wages and prices need to be free to fluctuate, so labor and other resources can be swiftly shifted away from bloated, bubble sectors of the economy and into sustainable sectors of the economy where consumers want them. Bailouts obstruct this process by preventing the reallocation of capital into the hands of firms that genuinely cater to consumer demand, and instead propping up those firms that do not. Fiscal and monetary stimulus, far from addressing these imbalances, only perpetuate them.

Note that the problem is not a decline in consumer spending. That's the usual analysis: why, people aren't spending enough! We need the government to stimulate consumption! To the contrary, there is if anything *too much* consumer spending. It is this relatively high consumer spending that is pulling factors of production back from the higher to the lower-order stages of production and making the existing pattern of resource deployment unsustainable. Stimulating consumption only makes the situation worse, by squeezing the already collapsing profitability of the higher-order stages (the stages, remember, that are the farthest from finished consumer goods).

There is no improving on Ludwig von Mises' metaphor of the master builder. An economy stimulated by artificially low interest rates is like a master builder engaged in the task of building a house that he lacks the materials to complete. If he discovers his error right away he can limit the damage. Perhaps only a small part of the house will have to be knocked down. Perhaps none of it will: it may suffice to alter his blueprint for the rest of the house in light of the decreased supply of building materials he now knows are available to him.

But what we do not want to do, in the name of helping him, is to get him drunk, hoping thereby to deceive him into thinking he has more building materials than he really does. This surely does *not* help him – now he may

not notice the problem until he has laid his very last brick. That puts him in a far worse situation than before: with no resources left and an unfinished house in front of him, probably the whole thing will have to be torn down, and all the materials and labor hours he expended on the project will have been squandered forever.

The artificially stimulated economy is like the master builder in that it, too, has become too ambitious in the face of the real level of resources at its disposal. Higher-order stages of production are being encouraged to expand at a time when no corresponding contraction has occurred in the lower-order stages, which indeed may actually be expanding. This cannot go on forever.

The story of the master builder also reveals that the real problem occurs during the boom period, not the bust. The artificial boom gives the superficial impression of prosperity — why, the master builder is employed, and he is producing goods for consumer use. But it is during the boom that resources are misallocated — i.e., when the master builder squanders building materials on a house he can never complete. The bust is the moment when his errors come to light, and he realizes he must modify his activities.

Likewise, the economy that, as a whole, appears to be prospering during a boom — and some of what occurs during the boom is indeed the generation of real wealth — is in fact engaged in a misdirection of resources. The bust or recession, painful as it is, is the necessary stage whereby resources are redeployed to lines of production that satisfy real consumer demand.

The classic example of trying to help by temporarily holding off a recession, thereby setting the state for a much worse recession years down the road — the equivalent of getting a temporary benefit by getting the master builder drunk — occurred in 2001.

Most observers cheered in the months following 9/11 when it seemed as if Alan Greenspan had successfully navigated the economy through the dot-com bust at the cost of only a relatively mild recession. The man the *New York Times* identified as “the infallible maestro of our financial system” had

lived up to expectations. But all Greenspan's interventions did was to hold off the inevitable recession, and make the downturn of 2007 and beyond all the worse. The recession of 2001 was the only one on record in which housing starts did not decline. From 2000 to 2001, home prices actually increased by 8.8 percent. Austrian economists at the time wondered about this. "What could explain a bull market in a non-earning asset in a non-inflationary era?" asked James Grant, editor of the famed *Grant's Interest Rate Observer*. The answer, he believed, involved artificial credit expansion and artificially low interest rates.³¹

So people drew the false conclusion — amplified by the alleged experts, including some Fed economists — that the housing sector is robust through thick and thin, housing prices never fall, a house is the best investment someone can make, and so on. Because Greenspan would not allow the full correction to take place, clearing out entrepreneurial errors caused by his previous fiddling with interest rates, market actors persisted in their errors for years thereafter. With the economy having continued along this unsustainable trajectory at that time, the bust that inevitably came was that much worse. This was the classic case of trying to help the master builder by getting him drunk. Yes, in the short run he keeps humming along, working on his project, but when he discovers his project has been unsustainable, all the extra time he spent on it because he was too drunk to notice the impending problem will have been a complete waste. And the same holds for the economy: had the adjustment come in 2001, we wouldn't have had a much more severe one in 2008.

Paul Krugman, columnist for the *New York Times* and winner of the 2008 Nobel Prize in economics, called for precisely this policy in 2001: force down interest rates to encourage lending and to stimulate the economy, housing in particular. Krugman told a German interviewer: "During phases of weak growth there are always those who say that lower interest rates will not help. They overlook the fact that low interest rates act through several channels. For instance, more housing is built, which expands the building sector.

You must ask the opposite question: why in the world shouldn't you lower interest rates."³²

Here is Krugman in October 2001: "Economic policy should encourage other spending to offset the temporary slump in business investment. *Low interest rates, which promote spending on housing and other durable goods, are the main answer.*"³³ Two months later he again spoke of the benefits of keeping housing strong by means of intervention in the economy: "The good news about the U.S. economy is that it fell into recession, but it didn't fall off a cliff. Most of the credit probably goes to the dogged optimism of American consumer, but the Fed's dramatic interest rate cuts helped keep housing strong even as business investment plunged."³⁴

But that turned out to be precisely the problem: by keeping housing "strong" instead of allowing the economy to correct itself, the Fed encouraged people to continue along an unsustainable path, thereby making the eventual and inevitable bust all the more severe when it finally arrived. Writing for the *New York Times* evidently means never having to apologize for being wrong — if you weren't wrong, you wouldn't be writing for the *New York Times* in the first place.

Alan Greenspan once declared his inability to discern any kind of common pattern between the various boom-bust cycles in American history. "There is always something different," Greenspan said, "something that does not look like all the previous ones. There is never anything identical and it is always a puzzlement." In fact, there *is* something identical — namely, artificial credit expansion. It is evident throughout all the nineteenth-century panics, and we likewise find it in the depressions and recessions of the twentieth and twenty-first centuries. Other features of the cycle may vary — there may be a spectacular rise in tech stocks in one case and in real estate in another—but this factor is consistently present. "How many more crises must we endure," wondered economist George Reisman in *Barron's*, "until we realize the common denominator is the creation of money and credit by the Fed? Wall Street bankers and speculators, who try to game the system and make

profits during each boom, are mere bit players in these crises. By fostering the booms and triggering the busts, the real villain is the institution of central banking itself.”³⁵

The Austrian theory of the business cycle strongly implies what should be done once the bust hits. Certainly all inflation of the money supply must come to an end. It was this policy, which brings artificially lower interest rates in its train, that caused the misdirection of resources into unsustainable lines in the first place. Further misdirection, even if we dignify it with the word “stimulus,” cannot repair the broken economy.

Prices and wages need to be free to fluctuate in accordance with changing conditions. The price system is the outcome of trillions of buying and selling decisions by business and the public. Entrepreneurs who are trying to figure out how to combine factors of production in such a way as to produce the goods consumers want at the lowest possible cost to society must refer to it. Any interference with prices and wages during the critical time in which bust evolves into recovery will subvert and thus delay the economy’s adjustment process. Only an unhampered system of prices and wages can ensure that the misallocated resources (including labor) of the boom are redirected to sectors of the economy where they conform to, rather than stand in inadvertent defiance of, consumer demand.

During a boom, labor and physical resources are attracted to sectors where, it will later be discovered, they did not belong. During the housing boom some 40 percent of all new jobs were in the housing sector.³⁶ That could not continue.

Failing firms need to be allowed to go bankrupt. The recession period is when a sustainable pattern of consumption and production is reestablished, and this pattern will not permit all firms to continue as before. Bankruptcy proceedings permit new owners to take over the assets of failing firms, and either conduct those firms according to a different business model, turn the assets (if possible) toward the production of different goods, or simply sell off

the assets and compensate as many of the creditors as can be accommodated.

The government's predation on the economy, in the form of spending and taxation, should be reduced. Resources are thereby released that entrepreneurs can use to realign the capital structure in light of the changed conditions the bust brought to light.

This strategy was followed in the depression of 1920-21, which saw unemployment shoot up to 12.4 percent and production decline by 17 percent. Wholesale prices fell by 56 percent. The political class today would be screaming for all manner of "stimulus" to reverse this death spiral. But the federal government at the time cut its budget in half from 1920 to 1922 and cut the national debt by one third over the course of the 1920s. (Income tax rates were lowered for all income groups throughout the decade, it's true, but these lower taxes took effect after the recovery was already in progress.) The Federal Reserve, for its part, did not engage in open-market operations (in which the Fed purchases assets with money it creates in order to increase the amount of money in circulation) to increase the money supply.³⁷ The economy was therefore allowed to adjust without the so-called countercyclical government policies that we are told are essential. Signs of recovery were evident by the late summer of 1921, which is when the National Bureau of Economic Research says the depression ended.³⁸ Joseph Schumpeter, one of the eminent economists of the twentieth century, contended that the 1920-21 case "shows better than any theory could how the system pulls itself out of troughs under its own steam."³⁹

Since 2007, the market has been trying to move consumers away from personal finance models based on indebtedness and consumption, and toward more saving and a sustainable level of consumption. To accommodate this shift, labor and capital will need to be reallocated out of some sectors and into other ones. As we've seen, "stimulus" spending only disrupts and confuses this purgative process, by misdirecting resources into arbitrary projects and artificially stimulating politically favored industries at the expense of the economy's healthy and productive sector. Barack Obama's program for recov-

ery, such as it was, looked instead to reinflate the bubble, keep the spending spree going, and give still more artificial stimulus to debt while introducing or exacerbating disincentives to save, rather than allow the market to correct the unsustainable excess in the economy.

“No scheme which has ever been devised...has ever made a collapsed boom go up again,” said William Graham Sumner in 1896.⁴⁰ Nothing in the historical record since then has altered that verdict.

NOTES

- 1 George Selgin, William D. Lastrapes, and Lawrence H. White, “Has the Fed Been a Failure?” Cato Institute Working Paper, November 9, 2010, 18ff., available at <http://www.cato.org/pubs/researchnotes/WorkingPaper-2.pdf>
- 2 Thanks to economist George Selgin for that line.
- 3 Selgin, Lastrapes, and White, “Has the Fed Been a Failure?” 17.
- 4 Ibid., 20.
- 5 See the extensive citations in *ibid.*, 9-15.
- 6 Richard H. Timberlake Jr., “Gold Standards and the Real Bills Doctrine in U.S. Monetary Policy,” *Independent Review* 11 (Winter 2007): 349.
- 7 The classic study of the Panic is Murray N. Rothbard, *The Panic of 1819: Reactions and Policies* (New York: Columbia University Press, 1962).
- 8 Murray N. Rothbard, *An Austrian Perspective on the History of Economic Thought*, vol. 2, *Classical Economics* (Brookfield, VT.: Edward Elgar, 1995), 212.
- 9 Ibid., 212-13; Murray N. Rothbard, *The Panic of 1819: Reactions and Policies* (Auburn, AL: Ludwig von Mises Institute, 2002 [1962]), 249; see also Clifton B. Luttrell, “Thomas Jefferson on Money and Banking: Disciple of David Hume and Forerunner of Some Modern Monetary Views,” *History of Political Economy* 7 (Spring 1975): 156-73. Rothbard’s book on the Panic was originally published by Columbia University Press.
- 10 Rothbard, *Classical Economics*, 213-16.
- 11 Charles R. Morris, “Freakoutonomics,” *New York Times*, June 2, 2006.
- 12 Again, 100 percent reserve banking would have prevented crises of this nature.
- 13 Andrew Jalil, “A New History of Banking Panics in the United States, 1825-1929: Construction and Implications,” unpublished working paper, November 1, 2009, available at http://www.ocf.berkeley.edu/~ajalil/Home_files/A%20History%20of%20Banking%20Panics%20in%20the%20United%20States,%201825-1929.pdf; cited in Selgin, Lastrapes, and White, “Has the Fed Been a Failure?”
- 14 Elmus Wicker, *Banking Panics of the Gilded Age* (Cambridge: Cambridge University Press, 2000), xii; Selgin, Lastrapes, and White, “Has the Fed Been a Failure?” 22-23.
- 15 Charles W. Calomiris, “Banking Crises and the Rules of the Game, NBER Working Paper 15403, October 2009, 11, 36.
- 16 Ibid., 35-38.
- 17 Jörg Guido Hülsmann, *The Ethics of Money Production* (Auburn, AL: Ludwig von Mises Institute, 2008), 91; Johan Norberg, *Financial Fiasco* (Washington, D.C.: Cato Institute, 2009), 143-44. The reference is to Michael Perkin and Robin Bade, “Central Bank Laws and Monetary Policy: A Preliminary Investigation,” in *The Australian Monetary System in the 1970s*, ed. M. A. Porter (Melbourne: Monash University, 1979), 24-39.

18 Hülsmann, *The Ethics of Money Production*, 153.

19 This discussion of deflation is indebted to the work of Jörg Guido Hülsmann, in particular *The Ethics of Money Production* and *Deflation and Liberty* (Auburn, AL: Ludwig von Mises Institute, 2008).

20 If suppliers of factors of production will not lower their prices, that means they have profitable opportunities elsewhere to sell their goods. This is not deflation but the common, indispensable process of the free market whereby factors of production get bid away from less urgent uses, thereby rearranging the structure of production to conform to consumer demand.

21 Andrew Atkeson and Patrick J. Kehoe, “Deflation and Depression: Is There an Empirical Link?” *American Economic Review Papers and Proceedings* 94 (May 2004): 99-103; quotation on 102.

22 Joseph T. Salerno, “An Austrian Taxonomy of Deflation--With Applications to the U.S.,” *Quarterly Journal of Austrian Economics* 6 (Winter 2003): 93-96.

23 Ludwig von Mises, *The Theory of Money and Credit*, new ed. (New Haven: Yale University Press, 1953 [1912]), 438-39.

24 F. A. Hayek, “The Intellectuals and Socialism,” *University of Chicago Law Review* (Spring 1949).

25 William Baker, *Endless Money: The Moral Hazards of Socialism* (Hoboken, NJ: Wiley, 2009), 160.

26 Thomas F. Cooley, “The Federal Reserve Needs to be Boring Again,” [Forbes.com](http://www.forbes.com), May 13, 2009, available at <http://www.forbes.com/2009/05/12/federalreserve-bernie-sanders-ron-paul-opinions-columnists-talf.html>.

27 On money in a free society, see Hülsmann, *Ethics of Money production*, *passim*.

28 For a study of three of the best-known speculative bubbles in earlier centuries, see Douglas E. French, *Early Speculative Bubbles and Increases in the Supply of Money* (Auburn, Ala.: Ludwig von Mises Institute, 2009).

29 Jerry H. Tempelman, “Austrian Business Cycle Theory and the Global Financial Crisis: Confessions of a Mainstream Economist,” *Quarterly Journal of Austrian Economics* 13 (Spring 2010): 4-5. The *Economist* further acknowledged that “the recent business cycles in both America and Japan displayed many ‘Austrian’ features.” *Ibid.*, 5.

30 Raghuram Rajan, “Many Are the Errors,” *The American*, September 19, 2010, <http://www.aei.org/publication/many-are-the-errors/>

31 Norberg, *Financial Fiasco*, 6.

32 See <http://www.pkarchive.org/global/welt.html>. Thanks to Benjamin Lee and Mark Thornton for the Krugman quotations.

33 Lou Dobbs Moneyline, July 18, 2001, available at <http://www.pkarchive.org/ecoomy/MLO71801.html> (emphasis added).

34 *New York Times*, December 28, 2001, available at <http://www.pkarchive.org/column/122901.html> (emphasis added).

35 Robert Klein and George Reisman, “Central Problem: The Central Bank,” *Barron’s*, December 28, 2009.

36 Norberg, *Financial Fiasco*, 7.

37 The Fed’s discount rate did come down by mid-1921, but there the Fed was following the market. With prices falling so dramatically (consumer prices plunged 38 percent in a single year), the Fisher premium in the interest rate, which reflects inflation expectations, would have come down economy-wide. Historians have described the Fed as “largely passive” during the crisis.

38 For the full details of the depression of 1920, see Thomas E. Woods, Jr., “Warren Harding and the Forgotten Depression of 1920,” *Intercollegiate Review* 44 (Fall 2009): 22-29.

39 Joseph A. Schumpeter, *Business Cycles: A Theoretical, Historical, Statistical Analysis of the Capitalist Process*, vol. II (New York: McGraw Hill, 1939), 786-87. For a systematic defense of the 1921 example as a vindication of the Austrian approach, see Patrick Newman, “The Depression of 1920-1921: A Credit-Induced Boom and a Market-Based Recovery?” *Review of Austrian Economics* 29 (December 2016): 387-414.

40 William Graham Sumner, “The Delusion of the Debtors,” in *The Forgotten Man and Other Essays*, ed. Albert Galloway Keller (New Haven: Yale University Press, 1918), 170.

ABOUT TOM WOODS

Tom Woods is the *New York Times* bestselling author of a dozen books, including *Meltdown* (on the financial crisis, and featuring a foreword by Ron Paul) and *The Politically Incorrect Guide to American History*. A senior fellow of the Mises Institute, Tom holds his bachelor's degree in history from Harvard and his master's, M.Phil., and Ph.D. from Columbia University.

Tom has appeared on CNBC, MSNBC, FOX News Channel, FOX Business Network, C-SPAN, and Bloomberg Television, among other outlets. He won the \$50,000 first prize in the Templeton Enterprise Awards for his book *The Church and the Market*.

Tom created 400 videos on history and government for the [Ron Paul Curriculum](#), a K-12 homeschool curriculum.

For more about Tom, visit TomWoods.com.

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