

FREE MARKET

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THE MYSTERY OF CENTRAL BANKING

Robert Murphy

With the recent rate hike, the mainstream press obediently parrots the macroeconomic analysis offered by our friendly central planners at the Federal Reserve. The average citizen knows that he or she is not nearly smart enough to understand the complex interrelationships of various price indices, yield curves, consumer confidence, and so forth—that's Greenspan's job.

But the basic story, as told by our wise overseers, runs something like this: A high interest rate keeps prices down, but stifles business and prolongs unemployment. On the other hand, a low interest rate stimulates output and hiring but causes inflation. It is the job of the central bank to pick an interest rate j-u-u-st right, to achieve the optimal balance between these two extremes. (Indeed, I once read a financial analyst who actually used the term "Goldilocks" in describing Fed policy.) A good central banker knows when to cut rates to jump-start the economy out of a recession, but he also has the courage to "apply the brakes" by hiking rates when the economy begins to "overheat."

Standard Macro Models are Nonsense

As you may have inferred from my tone, I reject this popular analysis as utterly crude and pernicious. In a market economy, the interest rate is not merely a lever to stimulate or depress economic growth, and the connection between interest rates and inflation is far more subtle than the standard story suggests. The price of borrowing money has a "correct" value just as the price of a pair of shoes; the government cannot tinker with this value willy-nilly without causing drastic distortions.

Even putting aside theoretical objections (which we will analyze more fully below), the standard macroeconomic story has no historical support. The most obvious example is the Great Depression itself, which occurred a good 15 years *after* the Federal Reserve had been established to ostensibly dampen the vicissitudes of the wildcat free market.

In the 1970s, the US experienced "stagflation," i.e., simultaneous double-digit unemployment *and* inflation. This was impossible according

to the prevailing Keynesian orthodoxy, the equivalent of an economy that was both stuck in a rut *and* overheating at the same time.

More recently, Japanese policymakers were stumped in the 1990s when they couldn't improve their lackluster growth, despite nominal interest rates that were very close to or even literally zero percent. At that point, they had hit a wall; you can't cut rates lower than zero, since lenders would do better to stick their funds under a mattress. (I saw a lecture by Paul Krugman in which he told us that his advice to the Japanese central bankers had been to credibly announce very high rates of future inflation, which would cause the *real* rate of interest in Japan to become negative.)

As these historical episodes illustrate, even the staunchest proponent of central banking would have to concede that it is more an art than a science. "Exogenous" parameters in macroeconomic models can always change, such that the "optimal"

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policy move turns out, in retrospect, to be dead wrong. But isn't this true in all fields? Shouldn't we just give the macroeconomists more time to accumulate statistics and generate even more sophisticated mathematical models?

No, we shouldn't give the policy wonks another decade to tinker, because in this case it is the arrogant and ignorant mismanagement of the central bankers itself that is the major source of macroeconomic instability. As with other areas of government meddling in the economy, political "remedies" only serve to exacerbate (or indeed, often *cause*) the very problems they supposedly solve.

An Analogy

To appreciate the damage wrought by central banking, it may help to change the context in order to break free of habitual modes of thought. To that end, imagine that there is no Federal Reserve System, but rather a Federal Housing System. This organization is entrusted with a printing press, with which it can literally run off perfectly legal, crisp \$100 bills. Every month, the Fed prints new greenbacks and distributes them to a select group of housing developers, giving the new money in proportion to how many houses a particular builder constructs in a given period. This privileged group then uses the newly printed money (in addition to other funds) to buy lumber, bricks, etc. and to hire workers to construct new houses, which are then sold to homeowners in the normal fashion.

What would be some of the major effects of this hypothetical arrangement? Well, the newly injected \$100

bills would allow the builders to bid up the prices of lumber and other materials, siphoning these resources away from other uses, and causing more homes to be built than would otherwise have occurred. Especially on the heels of a bigger than expected injection of cash, there would be an apparent boom in the housing industry, as builders increased their orders for materials and hired more laborers to complete their projects. Because of the government subsidy, the housing industry would be more profitable than before, and competition among builders would eventually lead to a fall in housing prices for consumers.

Of course, running off new \$100 bills from the Fed's printing press would cause a rise in the price level, first in the prices of lumber, shingles, windows, etc., but eventually in the prices of *all* goods and services, as the extra cash worked its way throughout the entire economy. The people running the Federal Housing System would soon learn that if they injected too much cash too quickly, it would cause massive dislocations in other industries (which need lumber, laborers, etc. too) and would lead to unacceptably high rates of price inflation. Of course, it would be very painful and disruptive to stop the printing press altogether, since this would put many builders out of business and cause a spike in housing prices. After such policy reversals, entire neighborhoods of half-built houses would be abandoned, serving as stark reminders of wasted resources.

After the Federal Housing System had been in place for some time, the private sector would become better at anticipating its actions. Analysts would devote their entire

careers to parsing the casual remarks by Fed leaders, and would run statistical tests on the data used by the Fed to determine how much cash to print in the upcoming months. (For example, perhaps the Fed would look at new homes per capita, or the rate of housing growth compared to inflation, in order to determine its "target price" for new homes.) As people came to expect the monthly injections of cash, the Federal Housing System would become less and less able to influence events. In order to boost employment, for example, the Fed would have to inject ever higher amounts of cash, in order to catch the ever savvier home builders by surprise and make their projects more profitable than they had originally reckoned.

Naturally, certain groups would have a vested interest in either high or low rates of money injection. Young couples, for example, would clamor for the Fed to print out more cash and push down the price of a new house. Older couples who held no mortgage, on the other hand, would write Letters to the Editor urging restraint on the part of the Fed, since they would want their older homes to retain their market value. In this environment, it would be up to the technocratic economists to advise the Fed on a fair and sensible amount of money injection to the housing industry, which would best balance the desires of everyone.

The Real World

I hope most readers will agree that the hypothetical Federal Housing System would be a horrible idea. In the long run, it would be far better for everyone involved—even new home buyers—to eliminate the

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extra source of uncertainty and political manipulation in the housing industry by abolishing the FHS. Freely established market prices would foster the best use of scarce resources to satisfy consumer desires, whether for housing, fancy dinners, or automobiles.

But if the reader has agreed with me thus far, then he or she must also endorse the abolition of the Federal Reserve System. Despite the mysticism of central banking, and the awe with which we mere mortals behold Alan Greenspan, there is no major difference between central banking in the US, and the hypothetical scenario I invented above.

After the Federal Reserve sets a "target interest rate," it achieves its goal by (among other things) literally creating money out of thin air. The process is obscured through intermediate steps (such as "open market purchases" of securities), but ultimately the Federal Reserve creates new deposits for major banks out of an accounting vacuum, and then allows its privileged clients to use these new deposits as the collateral with which the client banks issue new credit to borrowers. Because borrowers will seek a larger quantity of credit only at lower interest rates, the Fed can indirectly influence the various market rates of interest by controlling the amount of credit that its client banks can ultimately loan.

All of the effects described above (for the Federal Housing System) occur under the Federal Reserve System, except that in the latter case the damage is more widespread, since the credit markets affect virtually *all* industries. Rather than printing up new cash and handing it out to large home builders, in effect the Federal Reserve prints up new cash and hands it out to privileged lenders. The hypothetical Fed stimulated housing construction, but the real Fed stimulates all industries that engage in long-term projects.

As explained by the Austrian theory of the business cycle, the interest rate serves to coordinate the

intertemporal structure of capital goods. To put it simply, a high interest rate is a signal to producers that consumers are "impatient" and place a premium on production processes that involve a relatively short gestation period. A low interest rate, on the other hand, is a green light to producers to invest in processes that tie up resources for a longer period. (Notice that a process in which resource costs are rolled over for, say, 10 years will be more sensitive to the interest rate than a process in which resource costs are recouped by the final sale after, say, two years.)

Depending on factors such as technology, the supplies of various capital goods, and the willingness of consumers to postpone immediate consumption in order to enjoy higher consumption in the future, the Austrians believe that there is a "correct" market rate of interest at any given time (for loans with a specified level of risk). But a central bank interferes with the market's natural tendency to achieve these correct rates. In order to keep voters happy, the central bank habitually pushes rates lower than they ought to be, which causes the familiar boom period in which stock prices

soar and unemployment falls. But this artificial expansion is unsustainable, and inevitably leads to a bust period, in which many of the production processes must be curtailed or abandoned altogether, and workers in these lines must be laid off.

Conclusion

A short article such as this one cannot of course explain the subtle features of Austrian business cycle theory; the interested reader should consult Mises's discussion in *Human Action*. However, I hope that my analogy of the Federal Housing System has alerted the reader to the problems of our current arrangement. We will never rid ourselves of the boom-bust cycle until we remove our monetary and banking institutions from political manipulation, and return them to private individuals operating in a voluntary market. In light of the more sophisticated Austrian analysis, the standard macro theories regarding Fed policy and interest rates are hopelessly naïve and destructive. ● FM

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GOLD, NOW MORE THAN EVER

Llewellyn H. Rockwell, Jr.

In a growing economy with sound money, the purchasing power of your money should and would be always on the rise. Your dollar would buy more this year than last year, not only in terms of quality improvements but also in terms of price. This is another way of saying that prices would constantly fall for most goods and services just as they have for goods offered by the technology sector.

Today we demand that the price of computers and bandwidth fall month by month but we oddly expect the prices of many other goods to constantly rise (houses, education, health care, taxes). And so we adjust our expectations accordingly. It takes some imagination to see how the system would work if we were guaranteed our right to deflation.

The newest price data raise serious concerns that we are being robbed (that is what inflation is) by this government more than we know. In some ways, the return of constant upward price pressures on a level exceeding economic growth is a telling act of destruction, and a testament to the power of government to create messes where none need exist.

Our intuition tells us that falling prices are great for our pocketbooks because they leave more left over for savings or other forms of consumption. It is just as good for society at large. Our money becomes worth more and more, and hence our remunerative labors grow in value too. If inflation works as a stealth tax, deflation works as a tax refund.

Falling prices are a gift that the free market grants to all people, provided that the market's natural benevolence is not thwarted by central bankers and government officials. The market does this through technological innovations that make production more efficient, and a widening division of labor due to the much-derided phenomenon of globalization. We all benefit from computers and from trade with newly opened economies in Europe and Asia.

Socialists used to talk about working together as a community but global trade shows that the best way to work together as a community is to work separately and exchange to our mutual benefit. In this way, all people of the world can unite in the effort to raise productivity, increase efficiency, and—hugely important—drive down prices now and forever.

Thanks to the Federal Reserve and its monetary spigot, the value of our money continues to decline overall rather than increase as it should. We now face the largest increase in consumer prices in two and a half years. Since 1982, the dollar's value has fallen by half—this during a period usually described as low inflation!

As inflation has “returned,” the Fed promptly assured everyone that it would swing into action to prevent inflation from getting out of control. But it said nothing that would indicate that it might bear the responsibility for existing inflation. This familiar posture has been compared to the driver who watches only the rearview mirror but assures

his passengers that all is well up ahead.

In the most recent inflation report, overall prices are climbing: 7.5 percent annualized and 5.5 percent in the last quarter. Within the structure of the index itself, however, we find wide variety, with many prices falling but enough rising to generate a rapidly rising index (there is no such thing as an “inflation rate” as a scientific measure).

The big increases were in food and energy, particularly dairy and gasoline. So getting from place to place costs 5 percent more now than it did the same time last year (12.4 percent annualized from 3 months ago!). Medical care is still outpacing everything but food and energy. Housing too is rising.

Given productivity increases, globalization, technological improvements, and the world dollar standard that permits a seemingly limitless export of paper, it is darn difficult these days to cause across-the-board price increases. All pressures run the other way. These very pressures have enabled the Fed to keep interest rates at rock bottom, pump the money supply whenever they saw the need, and otherwise provide backup for the massive amount of debt that is being created by the federal government.

Food and apparel are two sectors that have benefited enormously from the impact of globalization, with constantly falling prices, despite monetary pressures for higher prices. Housing can't benefit from globalization, energy production is hugely shackled by state controls, and everyone knows how viciously government intervenes in medical markets.

The point is not to say that regulations and market impositions cause inflation, but rather that inflation will tend to hit sectors the least where free markets are working to push prices down, as they have in the apparel industry. The more the pressure for lower prices, the less impact the Fed's relentless inflation

will have on the industry (at least in the short term).

In the same way, there are additional factors contributing to the high price of medical services and energy. Socialism has inflated the demand for medical services and government restrictions have artificially limited supply. The insane War on Iraq, coupled with sanctions before that, has had a lot to do with restricting supply relative to demand for oil—and this exists alongside environment regulations, government land and water ownership, and taxes that limit profit opportunities from production.

And yet, despite all of this, the real culprit behind the price increases that have stolen your right to deflation is the Federal Reserve. The bout of money-supply increases

began after September 2001 and soared above trend line for the two years following. Finally, late last year, the Fed pulled back a bit and the money supply even fell for a time. But now we look again to find that this real deflation was only temporary. The money supply is currently rising again. Since 2001, the money supply has risen above its trend by more than \$400 billion.

Inflation robs us of our savings, redistributes wealth from savers to debtors, reshuffles property from consumers to those connected to the government, makes conducting business more difficult, and subsidizes short-term thinking at the expense of long-term planning. It drives people into the workforce who would otherwise not be there of their own choosing, and prevents

the market economy from working its magic of raising living standards every year.

So how do we guard our future against future inflation? We could wish for better central-bank managers and more responsible presidents, but our founders hoped that we would not become a government of men. Instead consider again the ideal method for securing the value of money against the depredations of state power: the gold standard. It takes away from the state the right to create money and forces those who rule to live according to their means. ● FM

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THE WAGES OF SINFUL ECONOMIC ARGUMENTS

Tom Lehman

A recent article in the *Wall Street Journal* is a perfect example of how bad economic arguments in support of good ends can be easily twisted and used to confuse the general public (Gwendolyn Bounds, "Argument for minimum-wage boost," 7/27/04, p. B3). When we engage in poor reasoning and faulty economic logic in support of a noble cause, we can end up doing much more harm than good in the pursuit of liberty and economic freedom.

Examples of this dilemma abound, and conservatives are especially prone to this type of error in reasoning. For instance, we frequently hear arguments in favor of free trade because free trade "boosts exports," ignoring the real benefits in the form of cheaper imports and a

better use of scarce resources. Arguments against socialism are often made on the basis that the system creates poor incentives rather than the bigger problem identified by Ludwig von Mises: socialism's inability to permit rational economic calculation.

In this political season, we hear daily arguments in favor of tax cuts as a means to "stimulate" the economy, rather than on the basis of efficiency in resource use and private property rights. And, especially relevant to the topic at hand, arguments are often made against raising the minimum wage on the basis that an increasing minimum wage will elevate prices or harm small businesses.

The news article in question was written as a response to just such an

argument. This argument goes as follows: An increase in the minimum wage cannot be justified because it will unfairly and disproportionately harm small businesses that, unlike large firms, cannot absorb the additional costs imposed by mandated higher minimum wages. Dynamic small businesses are responsible for a relatively large part of employment. If they cannot afford these higher labor costs, they will fail and go out of business, and workers will lose jobs. Ergo, a hike in the minimum wage cannot be justified.

As with most arguments, this one contains a kernel of truth. Indeed, the scenario it portrays is certainly possible and may result for some small business owners. However, using this argument against minimum wage laws puts one on very shaky economic ground, because it skirts the chief problem of minimum wages and diverts attention instead to that hallowed and sacred institution known as "small business." This may seem like an easy sell to the American public, but it is a lazy argument that fails on its economic

merits, as the news article makes patently clear.

In response, the author of the article points to a recent study released by the Small Business Administration's Office of Advocacy which finds that, surprise, small business firms in America are not in fact the low-wage sector of the economy that many people believe them to be. On the contrary, the report finds that, on average, small businesses tend to pay above the minimum wage in order to compete in the labor market and attract workers.

In reality, according to the SBA study, it seems that larger wholesale and retail discounting firms employ a proportionately higher number of minimum wage workers, in part enabling them to keep their prices low. Small businesses, on the other hand, must pay wages well above the minimum in order to attract and retain reliable and productive employees. The theory is that by paying higher "efficiency wages," small businesses may be able to reduce worker absenteeism and turnover, and also cut down on labor search and retraining costs associated with employee churn.

The author of the article does not reveal the details of the SBA study or suggest why it would be necessary for smaller firms to pay higher wages than larger firms to attract and retain workers with similar levels of skill and education. However, it is plausible that some form of "compensating differential" is at work in larger firms that is not available to employees in smaller firms.

Hence, the higher wages paid by smaller firms are necessary to offset the non-wage benefits of working for a large firm. For example, it could be that larger firms pay lower wages but offer better health care or sick-leave benefits as non-wage compensation. Or, it might be that larger firms have the capital resources to invest in a safer, cleaner, and more inviting workplace, offsetting lower wages. The prestige associated with working for a larger and

more well-known enterprise might also play a role. Either way, some form of amenity in larger firms (or its absence in smaller firms) must explain the wage premium paid by smaller firms, or it would not persist.

However, the conclusions of the Small Business Administration study, as reported in the newspaper article, are very revealing, and clearly indicate the extent to which even small business owners are infatuated with turning the power of government to their own private advantage.

Contrary to the arguments made by so many well-meaning but misguided opponents of the minimum wage, small business owners actually *favor* an increase in the minimum wage. The reasoning is that it would force their larger rivals to pay higher wages, thus making it more difficult for large firms to offer discount prices on wholesale and retail products. In other words, according to this news article, many small business owners desire an increase in the minimum wage as a way to

hamstringing larger firms that offer lower-priced goods and services and out-compete them in the marketplace. Small business owners who push for an increase in the minimum wage see it as a tool to prevent their larger rivals from realizing efficiencies in labor costs, partially insulating themselves from the intense competition created by large-firm economies of scale.

Of course, this tactic should be seen for exactly what it is: typical rent-seeking behavior by less efficient firms who, rather than finding creative ways to cut costs and lower prices, reach for the lever of government coercion to hamper their more efficient rivals. This has been the history of government regulation for at least the last 100 years. Business firms support government intervention on some ostensibly noble grounds, such as reducing poverty or raising wages or enhancing consumer safety. In reality, their intent is usually much less dignified, supporting intervention only to create



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barriers that insulate them from competition.

Beyond this issue, however, the reasoning of the pro-minimum-wage argument made by some small business owners is itself dubious because, again, it ignores the primary problem associated with minimum wage laws to begin with. Minimum wage laws create unemployment among the lowest skilled and least educated workers. As any freshman economics student knows, wages mandated above the market-clearing equilibrium wage will create a binding price floor that causes the quantity of labor supplied to exceed the quantity of labor demanded, resulting in a surplus of labor. And, a surplus of labor leads to unemployment for those whose productive skill value is below the legal wage floor. The larger the increase in the minimum wage, therefore, the greater the labor surplus and the more detrimental the policy becomes.

For example, ask yourself if, all else equal, you would hire me for \$7 per hour if I can only generate an average of \$5.15 per hour of revenue for your firm. Clearly you would not. As a result, many unskilled workers who seek employment cannot find a job precisely because the government tells them that they

must be paid more than they are worth to a potential employer. Teenagers, and especially minority teenagers, are the most likely to fall into this low-skilled category. It should thus come as no surprise that teenage and minority teenage unemployment rates are among the highest of any demographic group, topping out, respectively, at 16.8 percent and 32.6 percent in June 2004, according to the Bureau of Labor Statistics. This compares poorly to a national unemployment rate of just 5.6 percent in the same month.

Thus, forcing larger rival firms to pay higher minimum wages will not necessarily lead them to raise prices for their goods and services, as some small business owners apparently believe. If the demand in the market for these products is price elastic (which is highly likely), these firms will not be able to raise prices and pass on higher labor costs to consumers. After all, this explains why small business owners despise paying "efficiency wages" in the first place: the inability to raise prices. Instead, it is probable that large firms faced with artificially higher labor costs will find it more advantageous to invest in additional technology and capital equipment that would replace the lowest skilled

employees who earn the minimum wage.

In the end, the singular most likely outcome is that a hike in the minimum wage will harm low-skilled employees who currently have a job working for a large firm by throwing them out of that job.

This recent news article and the story it tells is highly instructive for those who care about promoting free markets and economic liberty. Making bad economic arguments for noble economic ends puts us on shaky footing and opens the door for those arguments to be used against us. Arguing against minimum wage laws because they harm small businesses or lead to rising prices opens us up to just the kind of counterargument so vividly pointed out in this story. If minimum wage laws are not found to harm small businesses or lead to rising prices, then they must be ok. Of course, this is wrong. We must learn to always make the strongest and most consistent arguments against the enemies of free markets, or we will lose the battle. As Mises himself always reminded us, that requires constant study and a steadfast pursuit of the truth. • FM

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STUDENT GOVERNMENT BLUES

Daniel J. D'Amico

Colleges offer their students a taste of reality by simulating the political atmosphere of society with the presence of student government associations (SGAs). The election process succeeds in mimicking many aspects of real political campaigns: the cutthroat environment of

campaign promises combined with the relentless schmoozing of constituencies, and mindless pride.

Rather than encouraging students to be productive in the academic sense, this element of student life encourages students to popularize themselves no matter the costs and

regardless of ideology. The similarity that exists between class assignments and actual employment experience pales by comparison to how successful this process is at grooming our educated youths to love the unlovable arena of the political mainstream.

The development of SGAs at universities 100 years ago centered on the development of student honor codes. Now the presence of an SGA is standard at almost all universities. The noble efforts of SGA pioneers have mutated into leviathan-like

attempts to manage the intricacies of all aspects of student life. This judicial nature of the student government grew in its scope of influence to encompass student-organization chartering, budgeting, and troves of other student life operations.

SGAs maintain and create mountains of paperwork including meeting minutes, bylaws, and constitutions. This love for red tape probably elicits a great feeling of accomplishment in the hearts of these baby bureaucrats. SGA constitutions give actual legislative documents a run for their money, yet nowhere do they mention such essentials as going to class or maintaining a decent GPA.

Performing the role of a student government representative is similar to that of performing the role of an actual government representative. While making decisions on matters he has no expertise in, the rep appears knowledgeable and benevolent. Mastering this technique makes him the perfect candidate for political

office by achieving the most needed characteristic of governmental office: the ability to shirk responsibility.

An SGA activity that comes to mind is the issuance of student fees to student organizations. Student activities fees simulate the taxing mechanism of real governments. Each student is charged a mandatory fee that is collected and redistributed among student organizations by the authority of the SGA.

Most student organizations recognize a left-liberal bias that exists in the SGA budget allocation process. The same bias exists throughout the entire spectrum of university functions, thanks to the dependent relationship that has come to exist between the profession of education and government subsidy. The process of student budget allocation pitches students against students to bid for the attention and support of SGA in an interest-group fashion.

After viewing the SGA process of electing representatives, passing

inane motions, and allocating student fees, the general student body grows inevitably apathetic, disinterested, and generally annoyed at the presence of such a wasteful and purposeless organization. Voting turnouts for SGAs across the board are absolutely dismal, marking just one more striking similarity between these student operated playgrounds and the actual world of politics.

SGAs are only one form of civic organization that seems to mirror the worst aspects of modern politics. The only mystery is why we are constantly told to hold them all in high regard. The model students on campus should be those who study and excel in academics, not those who browbeat others into giving them power over others and money with which to exercise it. ● FM

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