The Inflation Tiger

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Notes:

This essay won the 2011 F.A. Hayek Award at George Mason University. The topic was: "Hayek famously warned that policy makers engaged in discretionary monetary policy are in effect holding a "tiger by the tail." From that perspective, how would you judge contemporary monetary policy since 2008?"

This essay was written on Federal Reserve System monetary policy, and not United States public policy. These two subjects are closely linked, but I did not address public policy issues because of the scope of the essay topic.

The Federal Reserve System is risking hyperinflation by intervening in markets using unprecedented actions. The implications of these actions will be studied for generations, but in the near term they could also mean the destabilization of the dollar. Therefore, monetary policy has become an even more urgent topic than normal. Many policies that the Federal Reserve System has employed are ultimately Keynesian interventionist theories. Friedrich Hayek would offer a vastly different remedy for this recession. Keynesian ideas have brought us out of a recession, but will it be at the cost of a roaring tiger of inflation? I believe that we can still spare ourselves hyperinflation with corrective action, but because of the nature of the Federal Reserve System's interventions, these actions will be extremely difficult.

Hayek is perhaps the most persistent and enduring critic of John Maynard Keynes. His most direct rebuttal of Keynesian interventionist policies comes in *The Pure Theory of Capital*. He states that the "Anglo-American" school would add capital to stimulate absolute demand in a contracting economy. Conversely the "Austrian" school would insist that only relative demand would change. The "Anglo-American" school analyses changes in demand in nominal terms while the "Austrian" school analyses in real terms (Hayek, *The Pure Theory of Capital* 70). Hayek writes, "The conception that we can maintain prosperity by keeping final demand always increasing a jump ahead of costs must sooner or later prove an illusion, because costs are not an independent magnitude but are in the long run determined by the expectations of what final demand will be" (Hayek, *A Tiger by the Tail*, 70).

Despite Hayek's criticism, Keynesian theories were practiced during much of his life. "We now have a tiger by the tail: how long can this inflation continue? If the tiger (of inflation) is freed he will eat us up; yet if he runs faster and faster while we desperately hold on, we are still finished!" (Hayek, *A Tiger by the Tail* 126). This is an exasperated scolding from a leading economist. We are now dependent upon our own ill-conceived government interventions to save us from previous ill-conceived government interventions. It is the embodiment of circular reasoning.

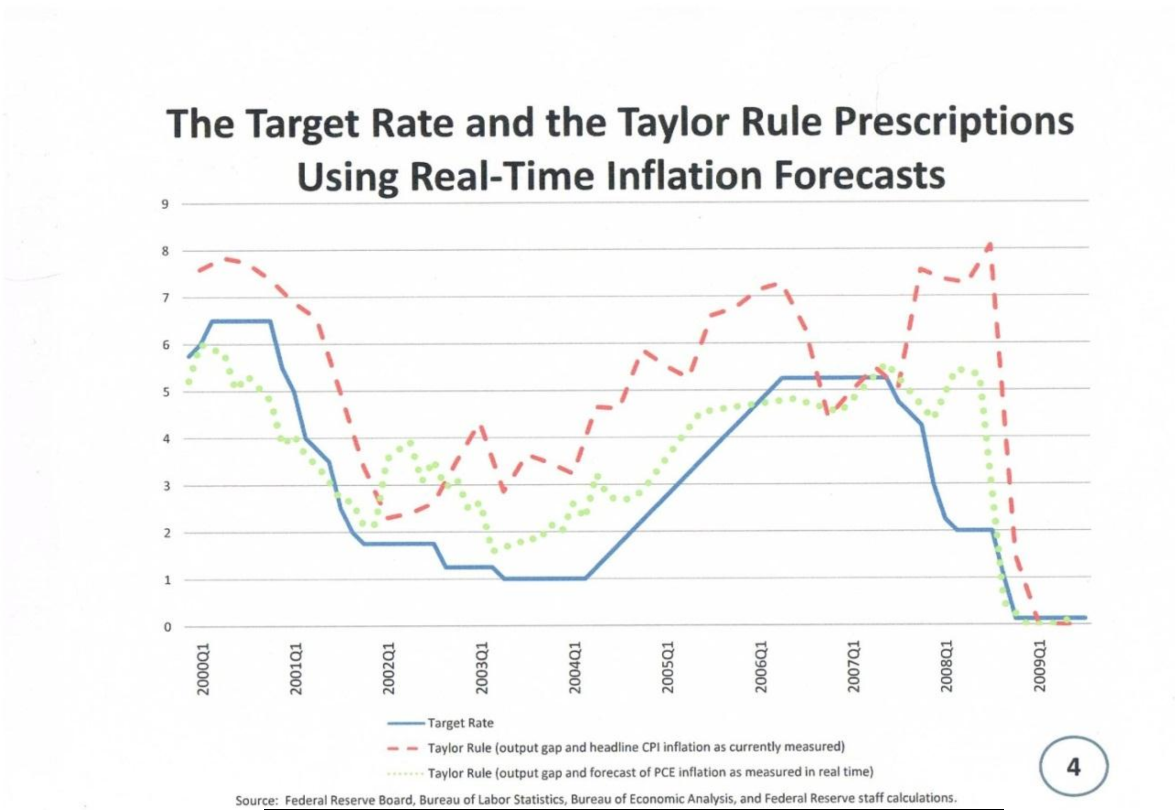
Hayek's main opposition to government interventions in markets is his fundamental belief in individualism. This is rooted in Carl Menger's description of value as subjective to the individual. "The measure of value is entirely subjective in nature, and for this reason a good can have great value to one economizing individual, little value to another, and no value at all to a third, depending upon the differences in their requirements and available amounts" (Menger 146). Hayek is grounded by Ludwig von Mises in the understanding that nominal values created by central banks must not be mistaken for real ones. "The demand for money is nothing but a real demand for capital; this must never be forgotten. If the undertaking takes up a short term loan to supplement its cash reserve, then the case is one of a genuine credit transaction, of an exchange of future goods for present goods" (von Mises, 316). He does not simply restate Say's law, that goods are exchanged for goods regardless of medium, but extends it to future goods (credit) as well.

So how does the Federal Reserve System (Fed) intervene in markets? The Fed indirectly controls the money supply through the regulation of member bank reserve requirements, the discounted rate at which the central bank makes loans to member banks, and the federal funds rate. The Federal Open Market Committee (F.O.M.C.) decides all policy related to the reserve requirements and rates. In practice the federal funds rate is actually a target which is then pursued by traders working for the Federal Reserve. When the Fed wants to lower the interest rate it increases the supply of money on a short term basis. It buys U.S. securities in a repurchase agreement with Treasury Department primary dealers. When the Fed wants to increase the interest rate it decreases the supply of money on a short term basis. It sells treasuries in matched sale-purchase agreements. If the Fed wants to enter into longer term changes in monetary policy, it buys or sells U.S. securities outright. These actions are the manner in which the Fed intervenes in the market under normative conditions. In the wake of the financial crisis the Fed has begun purchasing record amounts of U.S. securities, commercial bonds and mortgages, in a similar fashion, for similarly targeted reasons, in each specific market. In 2008 the F.O.M.C. lowered its discount and federal funds rate to 2% and finally to a floating point between 0% and .25%; a record low in the U.S.

The Fed has taken other unprecedented actions in response to the current financial crises. The Federal Reserve Bank of New York created a limited liability corporation called Maiden Lane to hold assets that were formerly owned by Bear Stearns investment bank. They did this to facilitate the purchase of Bear Stearns by JPMorgan Chase. They took similar action when they purchased warrants for American International Group (A.I.G.) (creating Maiden Lane II & III). These actions are outside of strict Keynesian policy.

Criticism may be directed at Keynesian theories for advocating direct central banking action and additional government spending in the economy (American Recovery and Reinvestment Act of 2009), but saving bankrupt private institutions using central bank assets is another matter altogether. These actions were taken to prevent contagion and systemic risk as posed by the collapse of Bear Stearns and A.I.G. It is unknown what Keynes would make of the Maiden Lanes. Perhaps it would fall within his “supply creates its own demand” (Keynes, *General Theory of Employment, Interest, and Money* 18) fallacy, but this would be a substantial assumption.

Monetary policy did not begin with the Fed or Keynes. In practice it is likely as old as money itself. In 1776 Adam Smith wrote that a bank which issued too much currency made the keeping of it more expensive (Smith, 383). More contemporaneously, Milton Friedman virtually created the monetarist school of thought. He developed his “k-percent rule,” which would increase the money supply by a set percent annually. (Friedman, *A Program for Monetary Stability* 50) He later developed “Friedman’s rule” which was a return to a quantity theory of value. This would set nominal prices static and allow real prices to adjust (Friedman, *The Optimum Quantity of Money* 52). John Taylor proposed using GDP and interest rates as variables in a math equation as a way of creating optimal interest rates. This rule is currently widely cited in academia, and by Federal Reserve officials as being a guiding rule of thumb. The chart below compares Taylor’s rule, a modification of the rule using the consumer price index, and the Federal Funds rate.



(Bernanke, *Monetary Policy and the Housing Bubble* 30)

Taylor's Rule: **r = p + .5y + .5(p – 2) + 2**

where: r is the federal funds rate
p is the rate of inflation over the previous four quarters
y is the percent deviation of real gdp from a target

that is: y = 100(y – y*) / y* where
Y is real gdp, and
Y* is trend real gdp

(Taylor, 202)

Many have argued for a return to the gold standard, the practice of pegging the currency to a set amount of gold. Hayek would find this preferable to interventionist policies, but states that gold is merely a "wobbly anchor" (Hayek, *Denationalization of Money* 82). Keynes is much more harsh in his attack of the gold standard, "It is obvious that it cannot be the gold in the Bank of England which enables industry to hum; for most of it lies there untouched from one year to another, and if it were to fade into air everything else could continue just as it did before – provided we were not told. To believe that the amount of working capital available for English industry depends on the amount of gold in the vaults of the Bank of England is to believe what is absurd" (Keynes, *A Treatise on Money*, 219). A return to the gold standard is more of an indication of the failure of central bankers to maintain price stability than the true merits of returning to an arbitrary commodity. According to Hayek it may be practically impossible for more than a handful of countries to return to the gold standard (Hayek, *Denationalization of Money,* 83).

Hayek preferred monetary policy over a gold standard, but he plainly opposed government's monopoly on the printing of money. He argued for the privatization of monetary policy; writing, "place the responsibility for the full use of resources back to where it belongs" (Hayek, *Denationalization of Money,* 76). According to Hayek, banks should be able to print their own currency. He argued that stable currencies would arise through competition among so-called 'free banks.' "Money is the one thing that would not make cheap, because its attractiveness preserves its dearness," (Hayek, *Denationalization of Money* 71-74).

H. Geoffrey Brennan and James Buchanan wrote that the monopolization of central banking was a method that the state used to practice tax farming. Tax farming is the practice of government's licensing monopolies and taxing those firms at a higher rate as a method of indirectly increasing taxes on the general public. In the case of a central bank practicing inflation, the tax farming operational method is inflation [see chart (Brennan, Buchanon, 43)]. When the United States practiced decentralized

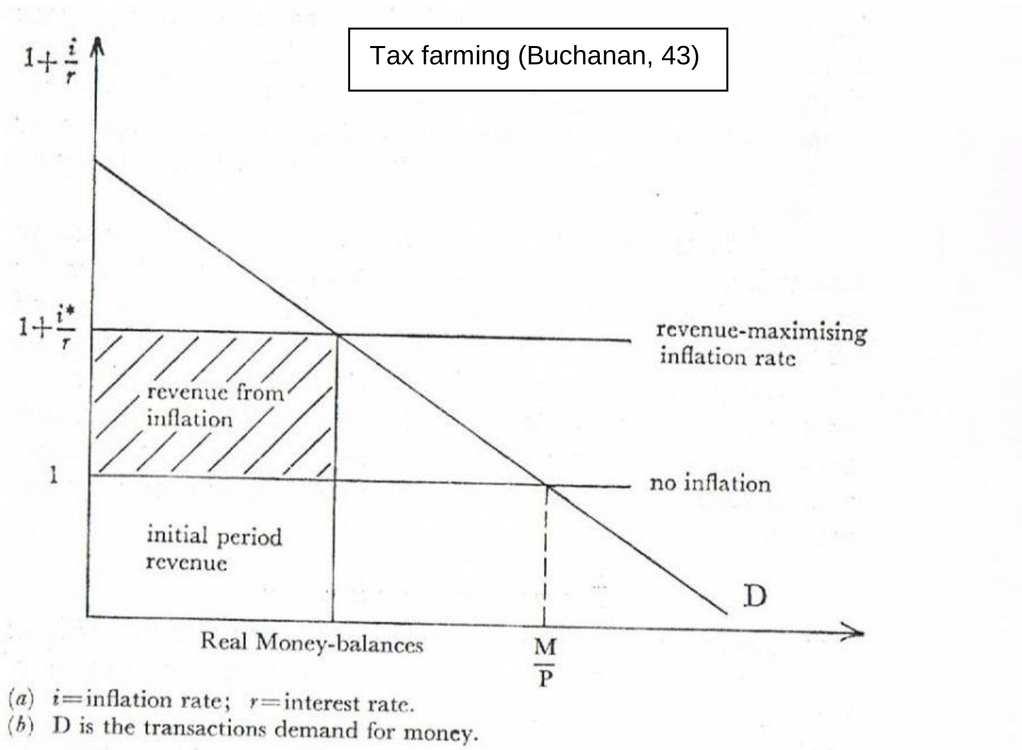


Figure 1

banking under the Articles of Confederation, the inefficiencies were considerable. James Madison described them, "The loss which America has sustained since the peace, from which the pestilent effects of paper money on the necessary confidence between man and man…" (Madison, 281).

Confidence is the foundation of the banking industry ultimately and this principle extends to central banking as well. Will the market have confidence that the Fed will be able to maintain price stability, or will fears of inflation overtake that? If relative price stability is to be sacrificed, are the effects of interventionist policies worth their causes? Knut Wicksell, an early influence on monetary policy, offers troubling insight to our present situation, “Easier credit sets up a tendency for production (and trade in general) to expand; but this does not in any way imply that production will in fact increase,” (Wicksell, 90). Ben Bernanke is his own best and most concise critic as he writes, “it appears that the benefits of expansionary policies (such as lower unemployment) are largely transitory, whereas the costs of expansionary policies (primarily the inefficiencies associated with higher inflation) tend to be permanent” (Bernanke, et al, *Inflation Targeting* 14).

Policy makers at the Fed have a difficult job. They have taken aggressive actions to counter deflationary pressures resulting from economic contraction. As the business cycle changes, the inflation tiger has shown itself again. I assert that keeping inflation from becoming hyperinflation is still possible. I support a more accurate application of Taylor’s rule, one where we are as quick to raise interest rates as we are to cut. Indeed, the true test of the Fed should not be how quickly it can lower interest rates, but rather how quickly it can raise them. The test should not be how quickly it can purchase treasuries, but how strong conviction is to sell them in the face of political opposition. We all know that the Fed has the tools to manage its currency, but will it have the courage to use them?

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