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RESEARCH REPORTS

AIER publishes over 100 articles per month that are distributed in digital form. Research Reports contains Business Conditions Monthly plus 12 of the most representative, chosen here for popularity, variety, and relevance. These articles are often reprinted in venues around the web, including *Seeking Alpha*, *Intellectual Takeout*, *Mises Brasil*, and dozens of other outlets. To read all of them, go to

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Contents

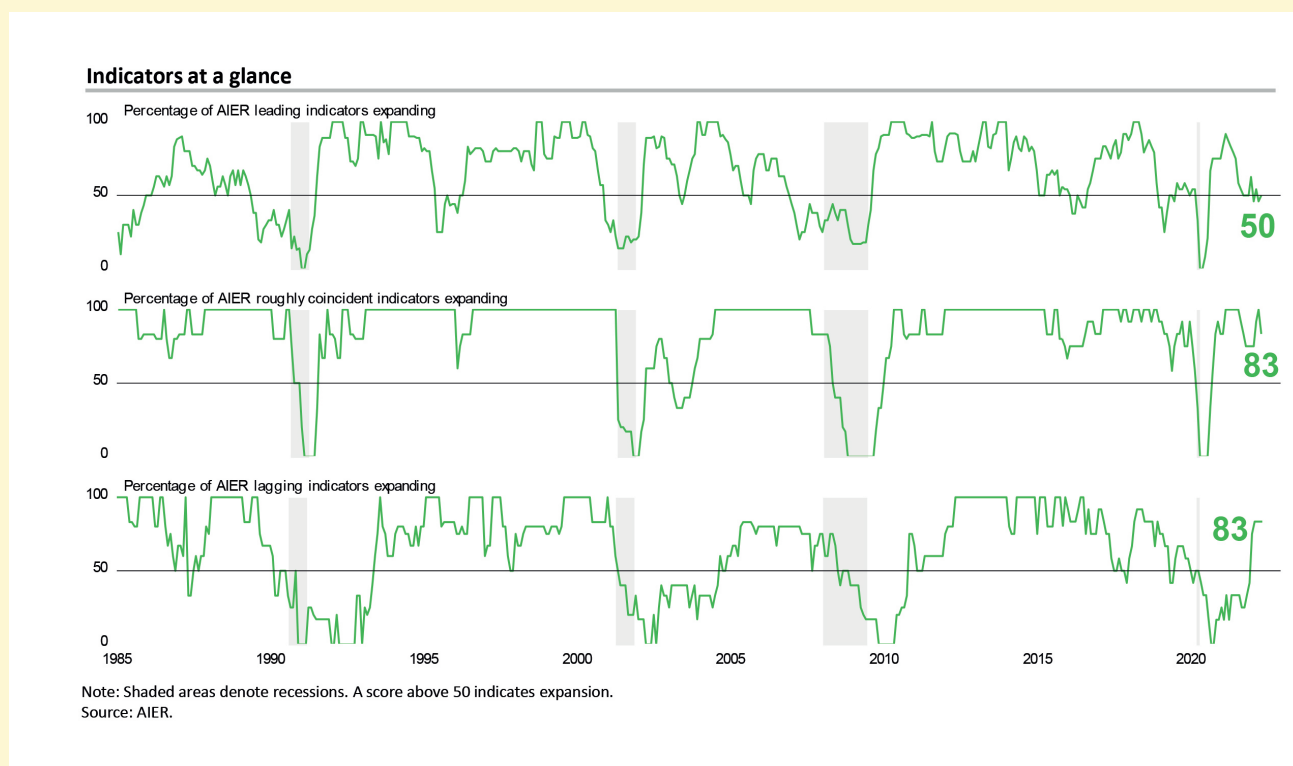
Business Conditions Monthly ROBERT HUGHES	1
The Renewed Politicization of the Federal Reserve THOMAS L. HOGAN	9
Inflation Slowed in April, But Remains High WILLIAM J. LUTHER	12
Inflation: What Causes It, and When Will it Subside? JAMES L. CATON	14
Let Them Eat Breast Milk ROBERT E. WRIGHT	20
Headed for Insolvency: Biden Administration Increases US Obligations Worldwide DOUG BANDOW	22
Power Economics SAMUEL GREGG	25
Should the Fed Devalue Our Currency to Implement Negative Interest Rates? LAWRENCE H. WHITE	28
The Federal Reserve's Moving Target JOSHUA R. HENDRICKSON	32
Rent Selling Countries are More Corrupt and Less Wealthy RICHARD M. SALSMAN	34
Income Distribution and Inequality ROBERT F. MULLIGAN	37
Let's Cancel Student Loans – Not Forgive Them, But Cancel the Program GEORGE LEEF	40
The Folly of Debt Cancellation PETER C. EARLE	42

BUSINESS CONDITIONS MONTHLY

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AIER Leading Indicators Index Returns to Neutral in May



Summary

AIER's Leading Indicators Index returned to a neutral 50 reading in May, rising four points following an eight-point fall in April. The Leading Indicators Index continues to fluctuate around the neutral 50 threshold, with the average over the last eight months holding at 51 (see chart). Over the last eight months, the Leading Indicators index has been above neutral twice, below neutral twice, and exactly neutral four times.

Board trends and risks of persistent upward pressure on prices, labor shortages and turnover, fallout from the Russian invasion of Ukraine, and lockdowns in China in response to outbreaks of COVID-19 remain significant forces impacting the domestic and global economies. Furthermore, a Fed tightening cycle raises the risk of a policy mistake. However, the strong labor market provides support for consumer incomes and spending, though it may also fuel a wage-price spiral.

While broad trends and risks continue, there are some signs of inflection in a few areas. Housing is showing some mixed signs while consumer sentiment has weakened, largely driven by the impact of persistent price increases. In addition, savings rates and spending as a share of income may be sending some early warnings. Caution is warranted.

AIER Leading Indicators Index Falls Back in May

The AIER Leading Indicators index posted a small bounce in May, gaining 4 points to 50 after falling 8 points in April. Over the last eight months, the Leading Indicators index has been above neutral twice, below neutral twice, and exactly neutral four times, putting the average reading over that time at 51.

Three leading indicators changed signal in May, with one weakening and two improving: the real retail sales indicator improved from a neutral trend to a favorable trend and the real new orders for consumer goods indicator improved from a negative trend to a neutral trend. Partially offsetting those positive results was a softening in the average workweek in manufacturing indicator, weakening from a positive trend to a neutral trend. Among the 12 leading indicators, five were in a positive trend in May while five were trending lower and two were trending flat or neutral.

The Roughly Coincident Indicators index fell back in May, dropping to a reading of 83 following two consecutive gains that put the index at a perfect 100 in April. One indicator weakened in May. The real manufacturing and trade sales indicator fell from a positive trend to a neutral trend. Overall, all five indicators – nonfarm payrolls, employment-to-population ratio, industrial production, real personal income excluding transfers, and The Conference Board Consumer Confidence in the Present Situation – were trending higher in May while the real manufacturing and trade sales indicator was in a flat or neutral trend.

AIER's Lagging Indicators index was unchanged for the fourth consecutive month, holding at 83 in May. February through May was the best four-month run since a four-month run at 83 from July through October 2018. No individual indicators changed trend for the month. In total, five indicators were in favorable trends, one indicator had an unfavorable trend, and none had a neutral trend.

Lingering materials shortages, labor shortages and turnover, and logistical problems continue to slow the recovery in production across the economy and are sustaining upward pressure on prices. Upward price pressures have resulted in a new cycle of Fed policy tightening, raising the risk of a policy mistake. Furthermore, the Russian invasion

of Ukraine and recent lockdowns in China in response to a recent wave of COVID-19 have launched a new wave of potential disruptions to global supply chains.

The outlook is for continued economic growth, but risks remain elevated. Consumer spending has been a solid source of growth but there may be some signs that the rate of growth in consumer spending may be unsustainable. Housing is also showing some signs of fatigue as record home prices and surging mortgage rates temper demand.

Additionally, 2022 is a Congressional election year. Intensely bitter partisanship and a deeply divided populace could lead to turmoil as confidence in election results come under attack. Contested results around the country could lead to additional economic disruptions and government paralysis, again testing the durability of democracy. Caution is warranted.

Retail Sales Post Strong Gains in April

Retail sales and food-services spending rose 0.9 percent in April following a 1.4 percent gain in March, with the increase from a year ago coming in at 8.2 percent. The latest retail sales data incorporate annual revisions. Revised data now show stronger upward trends for total and core retail sales.

Furthermore, these data are not adjusted for price changes. In real terms, total retail sales were up 0.6 percent (adjusted using the CPI) following a 0.2 percent increase in March and are also now showing stronger upward trends.

Core retail sales, which exclude motor vehicle dealers and gasoline retailers, rose 1.0 percent for the month, following a 1.2 percent gain in March. The gains leave that measure with an 8.2 percent gain from a year ago. After adjusting for price changes, real core retail sales rose 0.5 percent in April, the fourth monthly gain in a row, and are up 2.0 percent from a year ago.

Categories were mostly higher for the month with nine up and four down in April. The gains were led by a 4.0 percent increase in miscellaneous store retailers. Nonstore retailers and automotive retailers followed with 2.2 percent increases, while food services and drinking establishments (restaurants) had a 2.0 percent rise.

Gasoline spending led the decliners, down 2.7 percent for the month. However, the average price for a gallon of gasoline was \$4.37, down 0.7 percent from \$4.40 in March, suggesting price changes accounted for some of the move. Sporting goods, hobby, musical instrument, and bookstores sales were off 0.5 percent, and food and beverage store sales were down 0.2 percent.

Overall, retail sales rose for the month and revised data show a stronger trend in recent months. However, rising prices are still providing some boost to the numbers. Furthermore, persistent elevated rates of price increases are starting to have a negative effect on consumer attitudes.

Inflation Fears and Declining Buying Conditions Extend the May Drop in Consumer Sentiment

The final May results from the University of Michigan Surveys of Consumers show overall consumer sentiment continued to fall in the latter part of May. The composite consumer sentiment decreased to 58.4 in May, down from 59.1 in mid-May and 65.2 in April. The final May result is a drop of 6.8 points or 10.4 percent. The index is now down 42.6 points from the February 2020 result and at the lowest level since August 2011.

Both component indexes posted declines. The current-economic-conditions index fell to 63.3 from 69.4 in April. That is a 6.1-point or 10.0 percent decrease for the month and leaves the index with a 51.5-point drop since February 2020 and puts the index at its lowest level since March 2009.

The second sub-index — that of consumer expectations, one of the AIER leading indicators — lost 7.3 points or 11.7 percent for the month, dropping to 55.2. The index is off 36.9 points since February 2020 and is at the second-lowest level since November 2011.

All three indexes are near or below the lows seen in four of the last six recessions.

According to the report, “This recent drop was largely driven by continued negative views on current buying conditions for houses and durables, as well as consumers’ future outlook for the economy, primarily due to concerns over inflation.” However, the report adds, “At the same time, consumers expressed less pessimism over future prospects for their personal finances than over future business conditions. Less than one quarter of consumers expected to be worse off financially a year from now.” Furthermore, the report states, “Looking into the long term, a majority of consumers expected their financial situation to improve over the next five years; this share is essentially unchanged during 2022. The report’s take-away, “A stable outlook for personal finances may currently support consumer spending. Still, persistently negative views of the economy may come to dominate personal factors in influencing consumer behavior in the future.”

The one-year inflation expectations ticked down slightly to 5.3 percent in May, down from 5.4 percent in April. The one-year expectations has spiked above 3.5 percent several times since 2005 only to fall back. The five-year inflation expectations remained unchanged at 3.0 percent in May. That result remains well within the 25-year range of 2.2 percent to 3.5 percent.

The weakening trend in consumer attitudes reflects a confluence of events with inflation leading the pack. Persistent elevated price increases affect consumer and business decision-making and distort economic activity.

Strong Retail Spending May Not Be Sustainable

With retail sales continuing to run above the recent eight-year trend, measured as a share of disposable income and disposable income excluding government transfers, retail sales are 3.7 percent and 4.7 percent, respectively, above the pre-pandemic ranges of 3.0 percent to 3.4 percent for total disposable income and 3.8 percent to 4.2 percent for disposable income excluding transfers that persisted for the 2011 through 2019 period.

At the same time, the personal savings rate has fallen sharply, coming in at 4.4 percent of disposable income in April, well below the five-year average rate of 7.4 percent through December. That is the lowest rate since a 3.8 percent rate in August 2008, in the middle of the severe 2008 – 2009 recession.

Furthermore, total consumer credit outstanding rose by \$52.4 billion to \$4,539.0 billion in March, a 1.2 percent increase from the prior month. From a year ago, total consumer credit is up 7.3 percent.

Within the total, revolving credit, primarily credit cards, added \$31.4 billion to \$1,097.5 billion, a 2.9 percent gain for the month and a 12.8 percent jump over the past year. Nonrevolving credit added \$21.1 billion to come in at \$3,441.5 billion, a 0.6 percent gain for the month and a 5.7 percent gain from a year ago. Revolving credit made up 24.2 percent of total consumer credit while nonrevolving accounted for 75.8 percent.

New Single-Family Home Sales Plunged in April as Prices and Mortgage Rates Continue to Rise

Sales of new single-family homes plunged in April, declining 16.6 percent to 591,000 at a seasonally-adjusted annual rate from a 709,000 pace in March and just slightly ahead of the 582,000 pace at the bottom of the lockdown recession. The April drop follows a 10.5 percent decline in March, a 4.7 percent fall in February, and a 1.0 percent drop in January. The

four-month run of decreases leaves sales down 26.9 percent from the year-ago level (see first chart). Meanwhile, 30-year fixed rate mortgages were 5.3 percent in late May, up sharply from a low of 2.65 percent in January 2021.

Sales of new single-family homes were down in all four regions of the country in April. Sales in the South, the largest by volume, fell 19.8 percent while sales in the Midwest dropped 15.1 percent, sales in the West decreased 13.8 percent and sales in the Northeast, the smallest region by volume, sank 5.9 percent for the month. From a year ago, sales were up 17.1 percent in the Northeast but were off 12.4 percent in the West, down 25.5 percent in the Midwest, and off 36.6 percent in the South to the lowest level since December 2016.

The median sales price of a new single-family home was \$450,600, up from \$435,000 in April (not seasonally adjusted). The gain from a year ago is 19.6 percent versus a 21.0 percent 12-month gain in April. On a 12-month average basis, the median single-family home price is still at a record high.

The total inventory of new single-family homes for sale jumped 8.3 percent to 444,000 in April, putting the months' supply (inventory times 12 divided by the annual selling rate) at 9.0, up 30.4 percent from April and 91.5 percent above the year-ago level. The months' supply is at a very high level by historical comparison and is approaching peaks associated with prior recessions. The plunge in sales, high months' supply, and surge in mortgage rates should weigh on median home prices in coming months and quarters. However, the median time on the market for a new home remained very low in April, coming in at 2.8 months versus 3.9 in March.

Housing Activity Shows More Signs of Deterioration

The selling rate of existing homes decreased 2.4 percent in April, to a 5.61 million seasonally

adjusted annual rate. The selling rate is down 5.9 percent from a year ago.

The selling rate in the market for existing single-family homes, which account for about 89 percent of total existing-home sales, fell 2.5 percent in April, coming in at a 4.99 million seasonally adjusted annual rate, the first month below 5 million since June 2020. From a year ago, the selling rate is down 4.8 percent.

The single-family segment saw slowing sales in two of the four regions. Sales slowed 6.5 percent in the West and 5.6 percent in the South, the largest region by volume, while sales rose 3.7 percent in the Northeast, the smallest region by volume, and accelerated 4.2 in the Midwest. Measured from a year ago, sales were slower in all four regions (-11.1 percent in the Northeast, -8.3 percent in the West, -3.5 percent in the South, and -0.8 percent in the Midwest).

Condo and co-op sales slowed by 1.6 percent for the month, leaving sales at a 620,000 annual rate for the month, their slowest pace since July 2020, versus 630,000 in March. From a year ago, condo and co-op sales were 13.9 percent slower.

Condo and co-op sales were slower in two regions in April, -11.1 percent in the Midwest and -8.3 percent in the Northeast, but unchanged in the West and 3.6 percent faster in the South. From a year ago, sales were slower in all four regions (-19.4 percent in the South, -11.1 percent in the Midwest, -8.3 percent in the Northeast, and -6.7 percent in the West).

Total inventory of existing homes for sale rose in April, increasing by 10.8 percent to 1.03 million (the first result above one million since November) leaving the months' supply (inventory times 12 divided by the annual selling rate) up 0.3 month at 2.2, the highest since October, but still extremely low by historical comparison.

For the single-family segment, inventory was up 12.3 percent for the month at 910,000 but is 7.1

percent below the April 2021 level. The months' supply was 2.2, up from 1.9 in the prior month.

The condo and co-op inventory was unchanged at 118,000, leaving the months' supply at 2.3, up from 2.2 in March. Months' supply is 17.9 percent below April 2021.

The median sale price in April of an existing home was \$391,200, 14.8 percent above the year ago price. For single-family existing home sales in April, the price was \$397,600, also a 14.8 percent rise over the past year and a record high. The median price for a condo/co-op was \$340,000, 13.1 percent above April 2021 and a record high.

Housing is likely to be volatile over the coming months as fundamentals adjust to changing market conditions. Increased opportunities for employees to work remotely are likely to impact demand while supply chain issues and labor difficulties impact supply. Furthermore, record-high prices and the recent surge in mortgage rates will likely push some buyers out of the market.

CAPITAL MARKET PERFORMANCE

(Percent change)

	May	Latest 3M	Latest 12M	Calendar Year			Annualized		
				2021	2020	2019	3-year	5-year	10-year
Equity Markets									
S&P 1500	0.1	-5.5	-2.3	26.7	15.8	28.3	14.3	11.1	12.1
S&P 500 - total return	0.2	-5.2	-0.3	28.7	18.4	31.5	16.4	13.4	14.4
S&P 500 - price only	0.0	-5.5	-1.7	26.9	16.3	28.9	14.5	11.4	12.2
S&P 400	0.6	-5.5	-7.8	23.2	11.8	24.1	11.6	7.9	10.5
Russell 2000	0.0	-9.0	-17.9	13.7	18.4	23.7	8.4	6.4	9.4
Dow Jones Global Large-Cap Index	-0.2	-6.7	-8.3	16.2	14.7	23.8	9.8	7.2	8.1
Dow Jones Global Large-Cap ex-U.S. Index	0.3	-6.6	-14.3	4.9	8.8	18.2	4.1	2.1	3.8
STOXX Europe 600 Index	-1.6	-2.2	-0.8	22.2	-4.0	23.2	6.3	2.6	6.3
Bond Markets									
iShares 20-plus Year Treasury Bond ETF	-2.4	-16.7	-15.8	-6.0	16.4	11.5	-4.0	-1.3	-0.9
iShares AAA - A Corporate Bond Fund	1.5	-6.7	-11.2	-4.2	7.1	9.1	-1.9	-1.0	NA
Commodity Markets									
Gold	-3.3	-3.1	-3.2	-4.0	24.8	18.7	12.4	7.8	1.7
Silver	-7.1	-10.6	-21.2	-12.8	46.8	16.7	14.6	4.7	-2.5
Refinitiv CoreCommodities CRB total return index	2.8	17.9	54.3	38.5	-9.3	11.8	22.5	13.2	2.1

Sources: Barrons, Dow Jones, Frank Russell,
iShares, Standard & Poor's, STOXX Europe 600, Refinitiv.

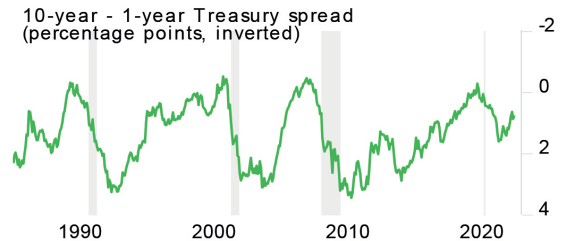
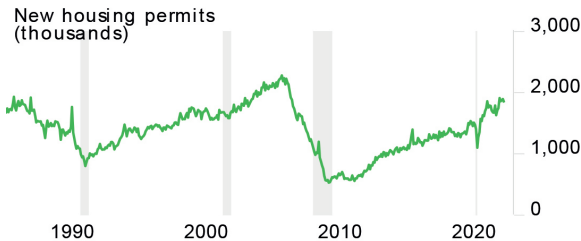
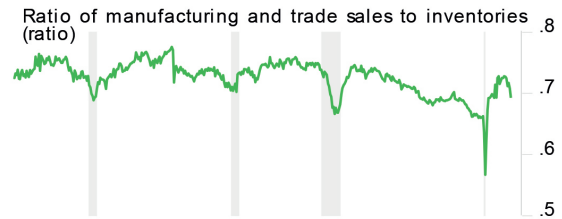
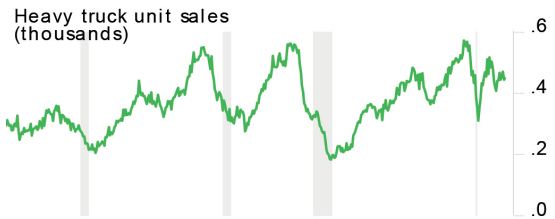
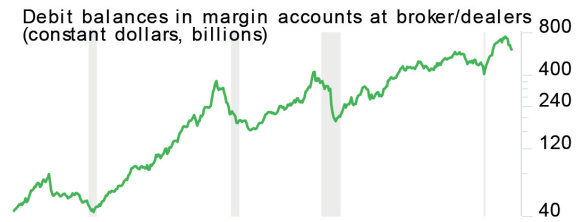
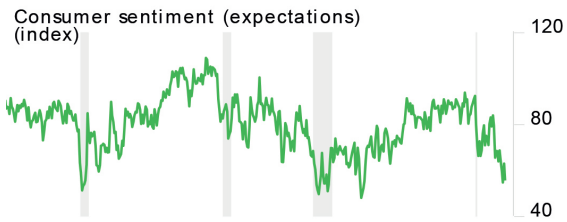
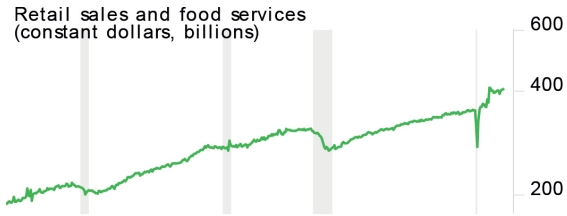
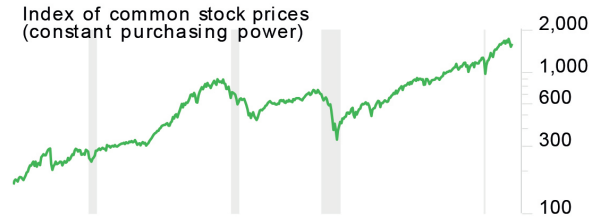
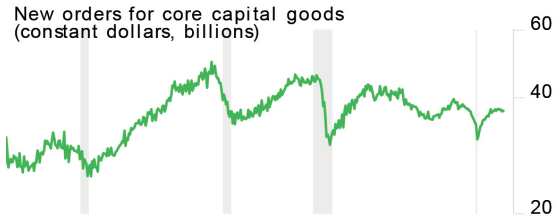
CONSUMER FINANCE RATES

(Percent)

	May	Latest 3M	Latest 12M	Average for Year			Average over Period		
				2021	2020	2019	3-year	5-year	10-year
30-yr. fixed mortgage	5.2	4.8	3.5	3.0	3.1	3.9	3.3	3.7	3.8
15-yr. fixed mortgage	4.4	4.0	2.8	2.3	2.6	3.4	2.7	3.1	3.1
5-yr. adjustable mortgage	4.1	3.7	2.8	2.6	3.1	3.6	3.0	3.3	3.1
48-month new car loan	4.9	4.9	5.0	5.1	5.1	5.4	5.1	5.1	4.7

Sources: Bankrate, Federal Reserve.

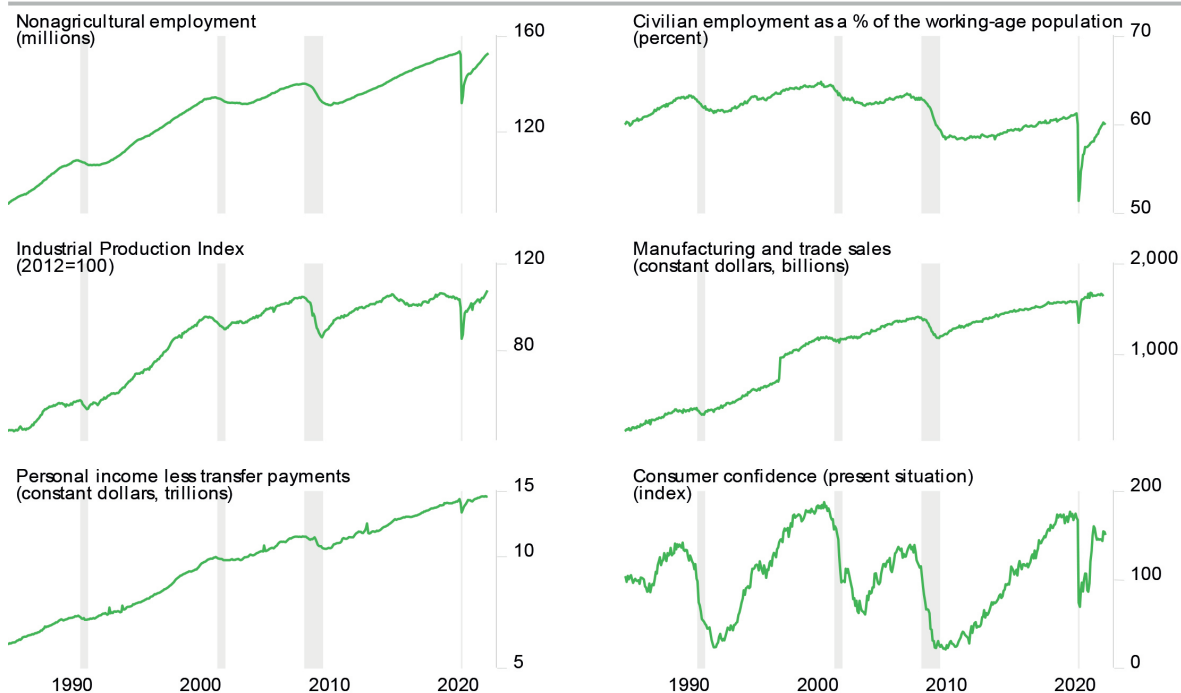
LEADING INDICATORS (1985-2022)



Note: Shaded areas denote recessions.

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, The conference Board, Census Bureau, Department of Labor, Federal Reserve, Institute for Supply Management, Standard & Poor's, AIER (Refinitiv).

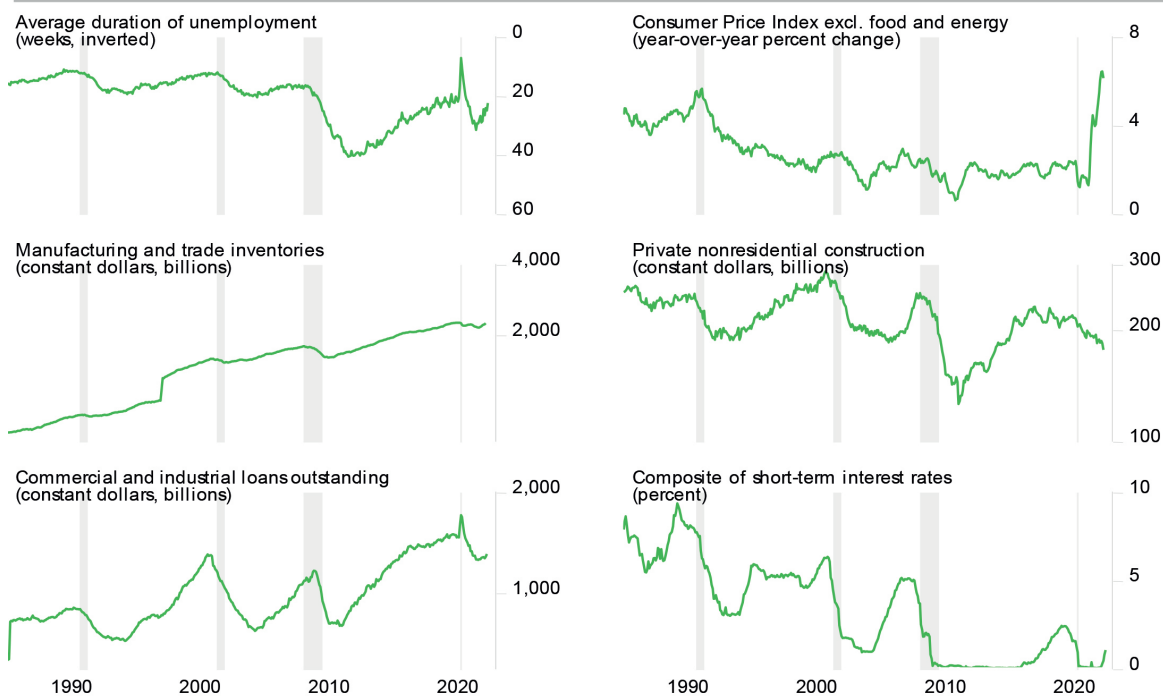
ROUGHLY COINCIDENT INDICATORS (1985-2022)



Note: Shaded areas denote recessions.

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, The conference Board, Census Bureau, Department of Labor, Federal Reserve, Institute for Supply Management, Standard & Poor's, AIER (Refinitiv).

LAGGING INDICATORS (1985-2022)



Note: Shaded areas denote recessions.

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, The conference Board, Census Bureau, Department of Labor, Federal Reserve, Institute for Supply Management, Standard & Poor's, AIER (Refinitiv).

The Renewed Politicization of the Federal Reserve

THOMAS L. HOGAN

Senior Research Faculty

Economic research shows that monetary policy works best when conducted by an independent central bank. After Fed chairs in the 1960s and '70s caved to pressure from American Presidents, those who followed sought, at least to some degree, to reestablish the Fed's independence. Until now, that is.

Since 2019, the Fed has politicized its activities in virtually every way: through its monetary policy goals, the use of its enhanced balance sheet, its regulatory actions, and its emergency lending activities. Each of these changes has pushed the Fed further from being an effective and independent central bank toward becoming a purely political institution, which prevents it from choosing the best policies for Americans and the US economy.

Monetary Policy: “Inclusive” Employment and (Flexible) Average Inflation Targeting

Fed officials, including current Chair Jerome Powell, have acknowledged that monetary policy is a broad tool that cannot be used to address the problems of racial and income inequality. Despite this admission, however, the Fed has injected the issue of inequality into its monetary policy goals.

In August of 2020, the Fed rewrote its statement of goals and strategy to emphasize employment ahead of inflation. The new language described the maximum employment goal as “a broad-based and inclusive goal that is not directly measurable.” Chair Powell cited racial differences in unemployment rates as a motivation for the change. This shifted the Fed's goal from focusing on the best outcome for most Americans to a purely discretionary target, which the Fed admits is impossible to measure.

At the same time, the new objectives stated that the Fed would target a rate of two percent inflation *averaged over time*, giving Fed officials greater ability to deviate from the prescribed rate of two percent annual inflation. Moreover, Fed officials have since revealed that they only intend to seek an average two percent when it has previously been below target. When inflation is above target, in contrast, the Fed will allow it to remain so and will not bring it down enough to return to the previous price-level trend.

Taken together, these two changes relax the traditional constraints on the Fed's ability to engage in overly-expansionary monetary policy. When warned that policy is too loose, they can point to their expanded employment goal to justify the policy. Then, when inflation rises above two percent, they can claim that it is temporary and will not affect the average rate of inflation in the future.

The irony is that such an approach would likely produce exactly the opposite of what is intended. To the extent that emphasizing maximum employment (in the broader sense) and ignoring temporary periods of above-average inflation results in overly-expansionary monetary policy, it risks recessionary corrections and even lower employment than would have occurred had the Fed stuck with its previous policy.

In early 2021, for example, Chairman Powell testified that the Fed planned to keep its interest rate targets near zero until the economy reached maximum employment, a policy it maintained throughout 2021 despite record inflation. Powell now says the US labor market is “unsustainably hot,” but the Fed has taken only minimal action to

calm the labor market or bring down inflation. Many commentators are already expressing concerns about a looming recession.

Balance Sheet Activities: Fiscal Accommodation

Through the use of large-scale asset purchases (LSAPs), also known as quantitative easing (QE), the Fed has massively expanded its balance sheet from less than \$1 trillion in 2008 to almost \$9 trillion today. While the federal government increased fiscal spending by \$5 trillion in response to the Coronavirus pandemic, the Fed bought up more than \$3.4 trillion in Treasury securities since 2019, effectively monetizing a large portion of the fiscal deficit.

While some economists applauded the Fed's fiscal accommodation, debt monetization is not a prudent action of a responsible central bank. Those that engage in such activities encourage profligate spending by their fiscal authorities, which often end up in fiscal default. Such massive purchases of Treasury securities were enabled by the Fed's enlarged balance sheet and would not have been possible in the pre-2008 system.

Emergency lending: Everyone Gets a bailout!

One traditional function of central banks is that they act as emergency lenders in times of financial crises. Although the Fed's 2008 emergency lending deviated from the rules of the classical lender of last resort, former Fed Chairs Bernanke and Yellen respected the limits of the Fed's authority as understood by economists and stated in the Federal Reserve Act.

Not so for Jerome Powell. Despite the fact that 2019 was not a case of "unusual and exigent" circumstances in terms of bank failures or shortages of financial liquidity, the Fed initiated a variety of emergency lending facilities beyond those of the 2008 crisis. The Fed lent to non-financial companies and state and local governments, which former Fed

chairs said it should never do.

These actions disturb the efficient allocation of capital in the financial system and further heighten the Fed's political profile.

Regulation: Climate and Industrial Policies

Bank regulators have increasingly used their regulatory powers to discourage banks from supporting politically unpopular industries, such as oil and gas, firearms, and medical marijuana. These punitive measures often take the form of discretionary enforcement actions, which lack the transparency and immutability of rules passed through the regulatory process.

Fed regulators have now turned their sights to climate change and the supposed threat it poses to US banks. The Fed subjects banks to "climate stress tests" and has joined international central banks' Network for Greening the Financial System (NGFS), whose stated goal is to "support the transition toward a sustainable economy." While these changes are ostensibly made in the name of limiting banks' risk exposure, their result in practice will be to harm the US economy by preventing banks from lending for specific purposes such as the production of energy and fossil fuels.

The Fed's Politics Threatens Its Independence

Fed officials have gone beyond policy discretion into overt political activism. President of the Minneapolis Federal Reserve Bank Neel Kashkari has been reprimanded by Senator Pat Toomey for his recent political actions. In 2020, former New York Fed President Bill Dudley argued that "Fed officials should consider how their decisions will affect the political outcome" by potentially withholding monetary accommodation in order to prevent the re-election of President Donald Trump. Such actions reveal these officials to be political opportunists rather than independent central bankers.

Independent central banks tend to deliver better monetary policy. But independence can only be maintained by focusing on the narrow goals assigned by Congress. By straying from its mandate, Fed officials have chosen to base their decisions on politics rather than on sound economics.

– May 5, 2022

Inflation Slowed in April, But Remains High

WILLIAM J. LUTHER

Director, Sound Money Project

The latest release from the Bureau of Economic Analysis shows that prices rose rapidly in April 2022, though not quite as fast as in the previous month. The Personal Consumption Expenditures Price Index (PCEPI), which is the Federal Reserve's preferred measure of inflation, grew 0.2 percent over the last month. It grew 0.9 percent in March and 0.5 percent in February.

Some will no doubt celebrate the decline in inflation. But a closer look at the data reveals little cause for celebration. The month-over-month decline appears to be entirely driven by the temporary surge in food and energy prices in March. More broadly, inflation remains high.

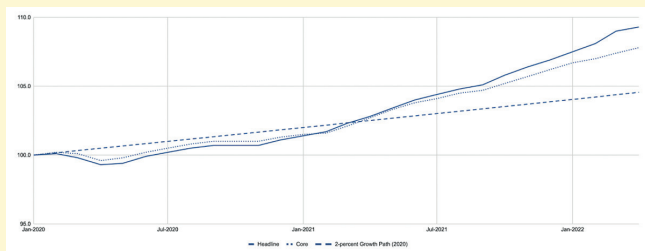


Figure 1. Personal Consumption Expenditures Price Index, January 2020 – April 2022

Headline and Core PCEPI are presented in Figure 1 alongside a 2-percent growth path projected from January 2020. Headline PCEPI, which includes all prices, grew at a continuously-compounding annual rate of 6.1 percent from April 2021 to April 2022. It has grown 4.0 percent per year since January 2020, just prior to the pandemic. Prices today are 4.7 percentage points higher than they would have been had they grown at 2 percent over the period, in line with the Fed's average inflation target.

Core PCEPI, which excludes food and energy

prices, grew at a continuously-compounding annual rate of 4.8 percent from April 2021 to April 2022. It has grown 3.3 percent per year since January 2020 and is currently 3.2 percentage points above the 2-percent growth path.

As Figure 1 shows, the slowdown in headline inflation does not coincide with a similar decline in core inflation. Supply disturbances—most notably, Russia's invasion of Ukraine—caused food and energy prices to surge in March. These prices remain high. The BEA reports energy prices were 30.4 percent higher in April 2022 than in the previous year, while food prices were 10.0 percent higher. But they are not growing as rapidly. Food prices grew 1.0 percent in April, compared with 1.4 percent in the previous month. Energy prices, which grew 11.7 percent in March, declined by 2.8 percent in April.

Taken together, the data show that prices continue to grow more or less as rapidly as they were prior to the uptick in March.



Figure 2. Breakeven PCEPI Inflation, January 2020 to May 2022

Forward-looking measures also give little reason to think the inflation tide has turned. Bond traders are currently pricing in around 2.76 percent inflation per year over the next five years and 2.42 percent inflation per year over the next ten years. As Figure

2 shows, breakeven PCEPI inflation—which is measured as the spread between traditional and inflation-indexed Treasuries, adjusted for the average difference between the PCEPI and the Consumer Price Index from 2010 to 2020—has declined over the last month, but remains above where it was in mid-February. On February 15, bond traders were pricing in around 2.69 percent inflation per year over the next five years and 2.28 percent inflation per year over the next ten years.

The Fed increased its federal funds rate target by 50 basis points in May 2022 and looks set to follow with similar rate hikes in June and July. The price level data from April shows no anticipatory effects of the policy. Perhaps we will start to see a lasting decline in inflation next month, but the breakeven PCEPI data suggests bond traders are not convinced. The Fed would need to do a lot more than is currently anticipated to bring inflation—and inflation expectations—back down to 2 percent in the near term.

– May 30, 2022

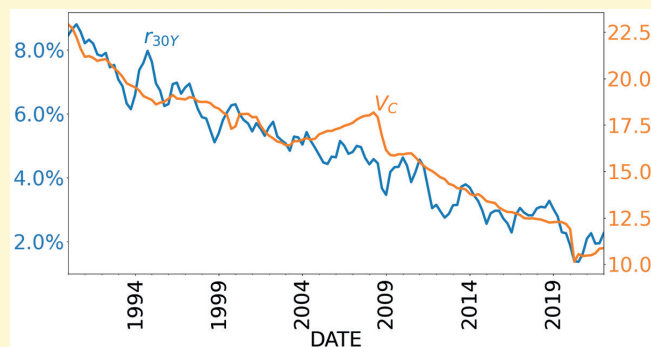
Inflation: What Causes It, and When Will it Subside?

JAMES L. CATON

Fellow, Sound Money Project

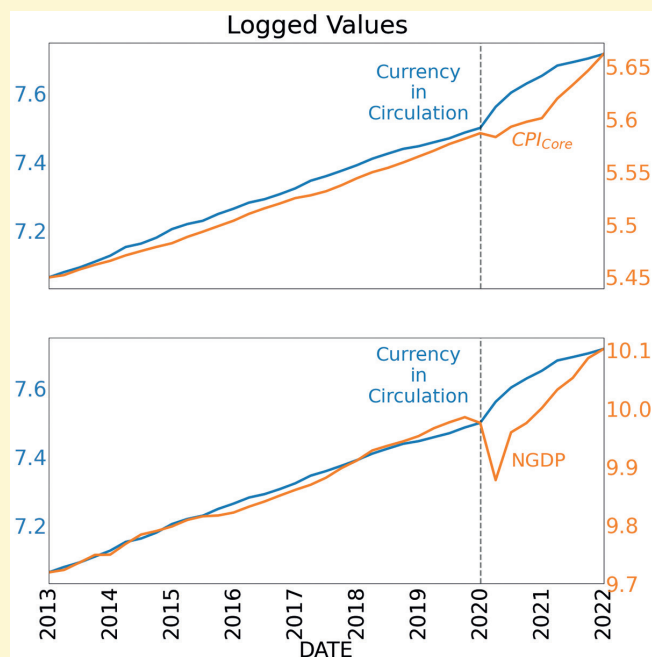
We have been living under an illusion that the relationship between nominal GDP and the quantity of circulating currency is dead. This illusion began in 2008, when the Federal Reserve began expanding the value of its assets without expanding the value of circulating currency. Instead, banks were paid to hold this newly created money on account at the Federal Reserve. The newly created money, thus, did not generate inflation despite expectations among many that high inflation was imminent.

In the long run, inflation is determined by the rate of expansion of circulating currency and growth in real productivity. Real productivity growth is deflationary, but tends to be modest and relatively stable. Thus, the growth rate of circulating currency tends to be correlated with the growth rate of total expenditures, as well as inflation.



After the 2008 Financial Crisis, the rate of inflation hovered around 1.7 percent. From the end of that crisis until recently, the velocity of currency trended downward modestly, mirroring the fall in long-term nominal interest rates. Figure 1 conveys this relationship between velocity of currency (right axis) and the nominal interest rate paid on 30-year US Treasuries (left axis).

It is true that an increase in the quantity of money will support a proportional increase in the level of expenditures, as long as the velocity of currency is stable. A more sophisticated expression of this truth holds that the velocity of currency is stable with respect to interest rates. Over the last several decades, the velocity of money currency has tended to follow the downward trend in interest rates. Although the relationship has not been 1-to-1, expansion of the stock of currency has tended to positively impact the level of total expenditures and the price level. For much of this period, the stock of circulating currency grew at a rate of about 7 percent while the rate of growth of nominal GDP was often in the range of between 3 percent and 5 percent.



In accordance with this logic, the FOMC has responded to increasing inflationary pressure by

reducing the growth rate of currency in circulation as the level of nominal GDP has broken above the pre-2020 trend. In the meantime, however, the balance sheet continued to expand into the first quarter of 2022. This recent correlation between balance sheet expansion and the annual rate of inflation has led many to believe that the Fed's current stance is too easy. The balance sheet increased for much of the previous decade without generating significant inflation. Circulating currency serves as reserves that support lending within the financial system. Policymakers and protocols governing monetary policy – for example, the Overnight Reverse Repurchase Agreement Facility – have supported stability in the level of currency in circulation. Stability in the path of NGDP tends to reflect stability in the path of circulating currency. Not coincidentally, the jump in the path of currency in circulation that began in the first quarter of 2020 has been followed by a similar jump in NGDP and in CPI (vertical line indicates start of first quarter of 2020). Those who would like to predict the future path of nominal GDP and of the price level should focus on currency in circulation, not the size of the balance sheet.

Inflation, Balance Sheet Expansion, and Fed Solvency

Claims linking inflation to the size of the balance sheet may stem, in part, from focus by Fed officials on the size of the balance sheet in recent months. Recent statements by Fed officials reflect that higher inflation readings have made these policymakers increasingly concerned about the size of the balance sheet.

Absent a solvency crisis, however, a larger balance sheet is most likely to be associated with lower interest rates and lower rates of real income growth. This program of balance sheet expansion, called quantitative easing, influences resource allocations by asset class and maturity length. While some might hope that quantitative easing stimulates

aggregate demand, there is little empirical evidence or theory to suggest that it does. Since the Federal Reserve began expanding the balance sheet greatly in excess of circulating currency, the rate of real GDP growth has fallen to historic lows. For much of this period, the level of GDP was below its potential path. And as the Fed began balance sheet reductions in 2017, these reductions were accompanied by relatively higher rates of real GDP growth. In the least, it is unlikely that quantitative easing supports expansion of aggregate demand.

Quantitative easing certainly impacts resource allocations. The Fed's acquisition of subprime mortgages during the 2008 Crisis lowered the risk of financial insolvency for firms that would have been left holding these mortgages. This was intended to help stabilize a housing market that was in meltdown and seems to have helped that market weather the liquidity crisis. Along with purchases of long-term US Treasuries, this policy was also intended to lower interest rates at the upper end of the yield curve. The most noteworthy effect of quantitative easing, then, has been to allocate credit toward particular classes of borrowers.

While balance sheet expansion has not been the cause of inflation over the last decade, this does not mean that the Federal Reserve can expand the balance sheet without limit. Balance sheet expansion absent expansion of circulating currency is not inflationary so long as there is not a mismatch between the assets and liabilities sides of the balance sheet. Assets yield income. On the other hand, much of the liabilities side of the Fed's balance sheet implies income payments that must be made by the Fed in order to maintain solvency. As long as the income earned by the Federal Reserve exceeds expenditures, the Fed remains solvent.

Expansion of the Federal Reserve's balance sheet simultaneously increases interest-earning assets and liabilities that require interest payments from

the Fed. The Federal Reserve prevents inflation by simultaneously borrowing the funds that it uses to pay for assets purchased. For example, the Federal Reserve may credit interest-bearing deposit accounts or may borrow funds at interest from the overnight lending market in order to offset currency created via its purchase of assets.

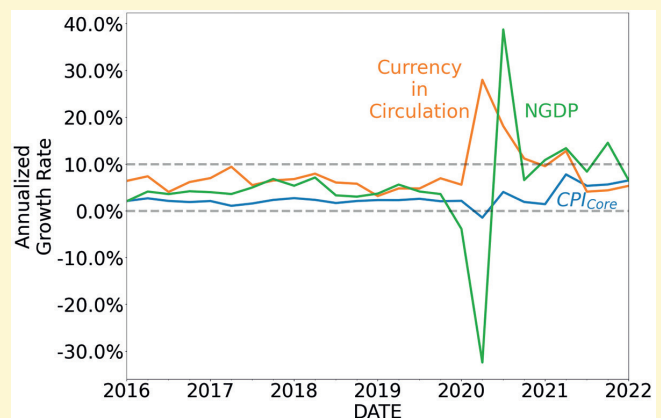
Monetary stability requires that the interest payments from the Federal Reserve are provided from the receipts adding to its income rather than from money creation. That is, Federal Reserve profits need to remain positive. Positive profits, defined by income above operating expenses, are remitted to the US Treasury. Negative profits either must be paid by the US Treasury or must be covered by the creation of new money. Negative profits would likely hurt investor confidence.

The assets side of the balance sheet is supposed to constrain the liabilities side. Insolvency occurs when the value of liabilities are not offset by the value of assets. Insolvency could occur, for example, due to rising interest rates. Suppose that investors lose faith in the ability of the Federal Reserve to maintain low and stable inflation. Rising mortgage rates would devalue mortgage-backed securities already held by the Fed that comprise a significant portion of the Fed's assets. Thus, as interest rates rise, the Federal Reserve will likely need to begin reducing the size of the balance sheet in order to 1) reduce losses on the assets side of its balance sheet and 2) to reduce interest payments that it owes to institutions and investors. As long as the Federal Reserve remains solvent and investors expect that it will remain solvent, a large balance sheet cannot, on its own, be the cause of inflation.

At present, there seems to be little reason to doubt the ability of the Federal Reserve to remain solvent as even doves like Lael Brainard, who was recently confirmed as Vice Chairwoman, are calling for aggressive tightening.

Will Inflation Continue to Rise?

As the year-over-year rate of inflation has increased, many commentators have begun to reflect on the relationship between easy money and inflation. However, few of these commentators have been consistently correct in their evaluation of Fed policy. Most do not differentiate between an increase in the Fed's balance sheet and expansion of currency in circulation. Over the last year, year-over-year rates of inflation have been rising as a result of the increasing rate of expansion of circulating currency orchestrated by the Federal Reserve during 2020. The good news is that annualized monthly and quarterly rates of inflation have been stable over the last year. The Federal Reserve began moderating this expansion of currency in circulation in the last year as nominal GDP returned to its pre-crisis trend. Nominal GDP has overshoot this trend, which is why we have been experiencing relatively high rates of inflation. But there is reason to expect that this overshoot is currently somewhere close to its greatest extent.



If excessive increases in inflation and the growth rate of nominal expenditures are caused by excessive increases in the growth rate of circulating currency, then we should expect inflation to ease in the near future as the rate of expansion of currency in circulation has moderated.

The swift expansion of circulating currency by the Federal Reserve helped expenditures to bounce back immediately after plunging in the second quarter of 2020. The growth rate of currency in circulation has been back to pre-crisis rates for at least 2 quarters. We should expect inflation and the growth rate of expenditures to follow and inflationary winds to subside as a result.

– May 18, 2022

Let Them Eat Breast Milk

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When I learned that Bette Midler's response to the baby formula supply crisis was "TRY BREAST-FEEDING," I immediately thought of two things, Marie Antoinette's "let them eat cake" and the end of *The Grapes of Wrath* (the book, not the movie). North of the Rio Grande, the parents of babies are livid at the Biden administration's cavalier attitude toward the problem, one that its Food and Drug Administration exacerbated by shuttering a production facility without clear cause.

Babies are reportedly being hospitalized due to the shortage. Reducing tariffs on European imports could solve the problem quickly, but even with a shuttered factory in Michigan due to reopen, shortages will likely remain for some months.

Thankfully, one of our few remaining free domestic markets could reduce the current suffering if people only knew about it. It's the market for human breast milk.

Yes, Bette, breast milk is good for babies. But new mothers must breastfeed regularly or they will quickly run dry. And for a variety of reasons not all new mothers can, or should breastfeed. In short, baby formula is a better choice for some, especially given that nobody could have magically foreseen that there would be unprecedented and unnecessary formula shortages in the near future.

The aged singer/actress Midler, who starred in *Ruthless People* opposite Danny DeVito, of Larry the Liquidator fame/infamy, among other roles, was merely chastised for her biologically ignorant comment. Marie Antoinette, the last queen of France, literally lost her head, though it is doubtful that she ever uttered "Qu'ils mangent de la brioche," or anything similar. The French chopped off her

noggin in October 1793 because she had helped her husband, King Louis XVI, wage policy war against the people of France: high taxes coupled with low public benefits and other forms of rent extraction, mixed with highly publicized personal consumption excesses, and some more secretive but heady sex stuff that you can read about in *Dangerous Liaisons*, if you are into that sort of thing.

Whether the Queen told starving peasants to eat brioche or not, the quotation and attribution eventually caught on because it was a very Marie Antoinette sort of utterance, as dismissive of the concerns of everyday people as Midler's tweet. Of course people don't sever heads from bodies anymore (with some notable exceptions I won't link to), we just sever ties with people who tweet insensitive things. But only some people apparently.

Given the economic woes currently facing the economy and the New Deal vibe coming out of the White House, though, *The Grapes of Wrath* is perhaps an even more disconcerting image elicited by Midler's tweet. At the end of John Steinbeck's 1939 best-selling novel, which depicted the struggles of migrant farmworkers during the Great Depression and New Deal, Rose of Sharon breastfeeds a man, a starving stranger, after her baby is stillborn.

Steinbeck's ending is more radical than the famous 1940 film adaptation directed by John Ford. To avoid the censure and banning that the novel endured, Ford allowed executive producer Darryl F. Zanuck to dilute the ending, which Ford had already altered from the novel, to Ma Joad in the family truck proclaiming that "we're the people – we go on." That ending allowed viewers to interpret the movie as one family's struggle during the Depression

instead of Steinbeck's controversial indictment of capitalism, a system where babies are born dead and grown men must suckle at the breast of women to survive.

The notion that "capitalism" caused the Depression, though, was one of the greatest dis-misinfoganda coups of all time. People who misunderstood the role of the stock market saw the bust of 1929 as the cause of the downturn when, in fact, it simply signaled a recession that policymakers later turned into a depression with dumb international trade and monetary policies under Herbert Hoover, and some absolutely disastrous New Deal policies under FDR.

Government work camps helped migrant workers like the Joads but they would not have been needed in the first place were it not for a litany of government policies that I will be describing in the coming year to commemorate the 90th anniversary of the founding of the American Institute for Economic Research in 1933. Then, as now, AIER fights inflationary currency, forced collectivization, and all forms of economic unfreedom, from the New Deal to Build Back Better. Help us to help you and yours by donating here. Due to some distortionary government regulations, every lil bit counts. USD preferred; no breast milk please.

If you do have a full breast of milk, consider donating or selling it to starving babies, though perhaps not directly as wet nurses did in the days of old. It is still legal, for now, even in often crazy California to sell your milk. There is a whole science behind maximizing its production.

– May 24, 2022

Headed for Insolvency: Biden Administration Increases US Obligations Worldwide

DOUG BANDOW

Contributor

Watching the Biden administration, you'd think Uncle Sam didn't have a care in the world. Washington is tossing more money at Ukraine, preparing to defend two more European nations, planning an Asia trip to enhance US alliances, sending troops to again battle Somali Islamists, and begging the new ruler of the United Arab Emirates to let America serve him better.

Yet the US is effectively bankrupt. The national debt already stands at 100 percent of GDP, nearing the post-World War II record. Deficits will remain about \$1 trillion annually even as COVID recedes. Democratic activists continue to press the administration to expand the federal soup line, with a massive student debt writedown. And Baby Boomers continue to retire, creating what will become a red ink tsunami in coming years.

Despite a world full of seeming chaos and conflict, America remains amazingly secure. There are no serious security threats in the Western Hemisphere. The challenges faced by America from governments it dislikes, such as Cuba, Venezuela, Nicaragua, and Mexico, are mere annoyances compared to the challenges faced by most other nations, including those on Uncle Sam's naughty list.

Indeed, the Biden administration admitted as much when it sent a delegation to Caracas to discuss the possibility of easing sanctions and returning Venezuelan oil to market. The US has been unable to oust the Maduro dictatorship, but most Americans haven't noticed. The lack of a competing power, let alone great power nearby, frees US policymakers to meddle around the globe.

Africa is a continent of much promise and tragedy. Somalia is a shell of its former self,

damaged by the struggle between the Soviet Union and US during the Cold War. President Joe Biden is sending American military personnel back to what remains of that nation. His purpose: to combat the al-Shabab Islamist militia and target its leadership. America's withdrawal, ordered by President Donald Trump, was long overdue. Alas, Biden's decision, noted in the *New York Times* by Charlie Savage and Eric Schmitt, "will revive an open-ended American counterterrorism operation that has amounted to a slow-burn war through three administrations." A plan for success that is not. Washington should leave the conflict to Somalis and their neighbors, which already are involved through the African Union.

Worse, and certainly more shameful, has been the administration's kowtow to the United Arab Emirates and Saudi Arabia. Washington spent decades sending US troops to act as royal bodyguards. There was plausible justification during the Cold War, when the Carter administration feared that the Soviet Union might seek to cut the West's oil supply. That vague possibility, never very serious, disappeared long ago.

Defense is one thing, but the US has armed and supported the Saudi led, UAE supported brutal war against Yemen, making American officials complicit in endless war crimes. Outrageously, the administration apologized for not acting quick enough to protect Abu Dhabi from Yemeni retaliation for killing thousands of civilians. And neither state is paying back past US favors, rejecting desperate begging by Washington to hike oil production.

The US should suggest that the Saudi and Emirati royals use their expensive arsenals for defense rather than offense. In truth, the biggest threat to those regimes now is internal—how many Emiratis

or Saudis want to die for a pampered royal elite? Let these regimes work together and with Israel to balance Iran, or even better, negotiate a modus vivendi allowing Sunnis and Shiites to live together in peace.

The President and Congress came up with \$40 billion for Ukraine, almost as much as Russia devotes to its military in a year and more than European nations, other than France, Germany, and the United Kingdom, spend annually. This also is far more than the Europeans have provided to Kyiv, even though their collective economy is almost as large as America's, and they long have refused to take their own defense seriously. Russia's attack on Ukraine obviously matters much more to them than to the US. Amid the Europeans' supposed military awakening, they should take the lead in backing Kyiv. So far, at least, the crisis that is supposed to energize European military outlays is costing Americans far more.

And that will get worse with the applications of Finland and Sweden to join NATO. Neither has been threatened by Moscow, which remains entangled in, and in danger of losing the war with Ukraine. Finland already has a competent force, and Kyiv has shown the way for Europe to defend itself devoting serious resources to territorial defense. The Europeans should focus on their security, not out-of-area excursions, such as in Libya a decade ago.

Neither Stockholm nor Helsinki is vital to America, which should be the primary criterion for Washington to issue a security guarantee. That is why the US and the rest of Europe refused to induct Ukraine into NATO, despite multiple promises to do so. No one was prepared to go to war for Kyiv with nuclear-armed Russia. There is no better reason to go to war with nuclear-armed Russia over Finland or Sweden.

And this would be primarily America's burden. If Russia attacked Finland along its 810-mile border, it wouldn't be Montenegro, Spain, or Italy that would

send troops. Nor would Germany, North Macedonia, or Greece respond if Moscow used nuclear weapons. Adding two new countries to NATO would expand Americans' military burdens yet again. President Eisenhower warned Washington against acting like "a modern Rome guarding the far frontiers with our legions." If Europe doesn't take over this burden when it perceives serious military danger, when will it do so?

And of course, there is Asia. The President is keen to restore America's alliances there, too, which naturally means spending more money. He invited ASEAN members—representing Southeast Asian states—to the US and then headed off to Asia for summits with members of the Quad, as well as South Korea's new president. The best response to China is friendly regional powers cooperating to constrain the People's Republic of China.

That, however, would require them to spend more money on their militaries and take responsibility for day-to-day security issues. Only now is Japan apparently ready to spend more than one percent of GDP on its military, after relying on the US to do the military heavy lifting for decades. The ruling party is talking about moving to two percent, but that is unlikely to occur unless Washington makes clear that the US no longer is going to be the guardian on station in the region. If someone should defend the unpopulated but contested Senkaku/Diaoyu Islands from the PRC, it should be Japan.

South Korea too. It carries a greater defense burden since the potential threat is bigger. The Republic of Korea has about 50 times the GDP, twice the population, and a vast technological lead over North Korea. And the ROK has come through the COVID pandemic while the North faces a potentially disastrous infectious tsunami with the Omicron variant having breached its sealed borders. Why should Washington continue to station an army division on the peninsula? Why shouldn't ROK units

be created and deployed to fill the gaps currently covered by US forces?

Foreign and military policy should reflect circumstances. A greater US role was required during the Cold War when friendly states were recovering from World War II, and both the USSR and PRC presented serious military challenges. That world is long over.

That doesn't mean that Washington faces no security challenges. They are, however, different. Most important, friendly states can do far more for themselves and their regions. Instead of risking Americans' lives further and longer and piling America's debt higher and wider, President Biden should be shifting security responsibilities from the US to its defense welfare recipients.

– May 29, 2022

Power Economics

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“I begin with the problem of economic power.” So commenced the first presentation given by the German ordoliberal economist Walter Eucken as part of a series of five lectures in early 1950 at the London School of Economics. Eucken was unable to complete these lectures as a result of a sudden and fatal heart attack at the age of 59. Eucken’s opening words, however, captured the essential concern that gave rise to the entire ordoliberal project of political economy and which bind its principles, modes of inquiry, and policy recommendations together.

That is the thesis presented by Raphaël Fèvre in his book, *A Political Economy of Power: Ordoliberalism in Context, 1932-1950*. To an extent greater than any other group of economists, Fèvre maintains, the first generation of ordoliberals were laser-focused on how to limit public and private power so as to bolster the type of economy that establishes order and promotes liberty. From this standpoint, according to Fèvre, ordoliberalism is best understood as “an autonomous form of economic knowledge driven by power issues.”

Such a position not only distinguished ordoliberalism from other schools of economics at the time. The attention to power also differentiated ordoliberal thought from postwar mainstream economics with its emphasis on building formal macro and micro-models verified by (or not, as the case may be) applied mathematics and statistics. For while ordoliberalism has much to say about economic theory and policy, it is far more an exercise in political economy than economics per se. Ironically enough, this may explain why ordoliberal thinkers have, despite their

relatively weak presence in the postwar academy (including in their German heartland), exerted more influence in politics and policy at particular points than most other market-orientated economists.

The Project and the New “Social Question”

Fèvre develops his interpretation of ordoliberalism’s rise and import through studying its emergence in the 1930s to the apogee of its influence in the 1950s. He shows how it developed through a series of interdisciplinary discussions and debates that addressed economic problems but also went beyond them.

But ordoliberalism’s advent is inseparable from the succession of economic and political crises that engulfed Weimar Germany and eventually helped facilitate the Nazi seizure of power in 1933, the subsequent development of a totalitarian state, and the economy’s gradual subordination to this form of government. The two people who Fèvre regards as the most important ordoliberal thinkers—Eucken and Wilhelm Röpke—wanted to develop long-term explanations of why nineteenth-century capitalism had faltered under a wave of “interventionist reaction” that, as Eucken wrote in 1932, was “born of a particular combination of economic interests, anti-capitalist sentiments, aspirations for a national polity, and quasi-religious convictions.”

Yet while there was considerable intentionality behind this endeavor, Fèvre also describes it as a process of “*crystallization* around a common project.” That project developed in three separate spheres. The first consisted of scholars living in exile like Röpke and Alexander Rüstow who sought to connect market economics to broader civilizational questions. The second was a circle of academics such as Eucken and Franz Böhm who remained in

Germany. They focused on questions of economic and legal theory but also engaged in the dangerous work of planning for a post-Nazi future. A third, smaller group consisted of figures like the economist Alfred Müller-Armack. He initially sought to work with Nazi technocrats and the German army to shape economic policy. Müller-Armack found, however, his advice being ignored, and consequently retreated into private academic studies, frustrated at the government's disinterest in his ideas and increasingly disturbed by the regime's evident lawlessness.

Despite the different realms in which they functioned during the 1930s and World War II, Fèvre sees all three groups as converging on the theme of power. By that, the ordoliberals had something specific in mind. Fèvre defines this as "the capacity of an actor to determine the structure of a specific economic order." That order includes the economic process but also the rules of the game. The actors themselves can be individuals but more commonly are groups or institutions. This was the analytical paradigm that ordoliberalism's founding generation applied to the interrelationships between moral norms, the economy, legal and constitutional structures, and their deeper roots in specific philosophical and religious traditions.

In subsequent chapters, Fèvre unfolds the different ways in which power functioned as an interpretative key for understanding the concerns and objectives of first-generation ordoliberals. Whether it was questions of institutional analysis, epistemological issues, or the comparative studies of economic systems, power was the locus, Fèvre argues, of ordoliberal thought. It was from this perspective, he maintains, that the ordoliberals sought to change the nature of the discussion of "the social question."

Throughout the nineteenth century, the social question preoccupying many European intellectuals, ranging from Marxists to Catholic corporatists, was the emergence of great wealth and a general rise

in living standards alongside an industrial working class whom many considered were exploited by the very same capitalist system which had delivered stupendous economic growth. Though these thinkers differed radically in what they thought should be done, they agreed that liberal capitalism was producing unbearable social and political tensions that threatened to tear industrialized nations apart.

For the ordoliberals, by contrast, the social question was of an entirely different scale and character. Human freedom, they insisted, was being pulverized by strong public and private economic powers. Whether it was the rapid expansion of state power via welfare states, tariffs, regulation, and industrial policy, or the dominance of entire economic sectors by cartels with strong ties to the political class, individual liberty was losing out. Reversing that trend through means like revitalizing competition and restoring a free price system was key to solving this social question. For that reason, ordoliberals placed a premium on taming the use of state power in the economy.

Ideas as Power

This last point underscores another theme pervading Fèvre's analysis. The ordoliberals were not content to study how economies were driven and distorted by the striving for and gaining of power. Certainly, they were interested in truth for its own sake. But first-generation ordoliberals also wanted to engineer a decisive shift in the German economy and, one suspects, throughout Europe more widely. Ironically enough, that required the exercise of power: intellectual, rhetorical, and political.

This is the other side of the ordoliberal project. If the exercise of power by authoritarians had been central to the German catastrophe, solving what Röpke called "the German question" required a decisive break with that conception of the state and its underlying philosophical apparatus. Here

Fèvre draws attention to how the ordoliberals in the postwar period highlighted the extent to which the Nazi regime had “Nazified” the economy by permeating it with the structures and priorities of top-down authoritarian rule.

The objective of the exercise was to associate central planning with the discredited National Socialist legacy. This put those Allied military occupation authorities who favored Keynesian and socialist policies in the awkward position of being seen as “perpetuating a system inherited from the Nazis.” That opened up the possibility that the Allies would come to understand de-Nazification as requiring rejection of the move towards more economic planning than dominating the rest of the Western world. The restoration of economic order also became understood as connected to the rejuvenation of competition, stable money, and free prices.

This will strike many as an instance of intellectual jiu-jitsu. In one sense that is true. The ordoliberals prepared the way for market-orientated reform by reversing prevailing assumptions about planning and markets. That’s the type of cleverness needed to overcome people’s resistance to substantive market-liberalizing changes. Without, however, the heavy-duty intellectual work of understanding how power shaped economic life, the rhetorical cunning would have counted for nothing. Shifting the political culture certainly matters when seeking to affect economic change; but the ordoliberals understood that if you lack a comprehensive understanding of why the economy is the way it is, you risk ending up not knowing where you want to take it and why you want to do so in the first place.

Success and Failure

Did the ordoliberals succeed? On one level the answer is yes. Fèvre points out that “ordoliberal culture permeates the entire political sphere [of Germany] and has become an almost mandatory

reference point for the German elite.” Even today’s Social Democrats find themselves compelled to pay lip-service to ordoliberal ideas. More concretely, the German Bundesbank’s reputation for being tough-minded about monetary policy and its emphasis upon following non-discretionary rules arguably reflects lasting ordoliberal influences. This was also the model upon which the European Central Bank (ECB) was based. Given that mainstream economics had come to dominate the German economics profession by the 1960s and crowded out an already small ordoliberal presence, these were considerable achievements.

At the same time, Fèvre stresses, there is much evidence of fading influence. Today’s ECB, for example, has drifted far from ordoliberal concerns, especially since the 2008 financial crisis and under the leadership of its former president Mario Draghi. It’s not just that quantitative easing is so contrary to ordoliberal principles such as the primacy of monetary stability. The post-2008 ECB’s willingness to play fast and loose with constitutional constraints to address immediate problems is symptomatic of the same trend. More generally, it’s not obvious to me that contemporary EU political leaders—including German politicians—show many signs of being influenced by the substance of ordoliberal ideas.

Notwithstanding these failures, the writings and activities of ordoliberalism’s first generation remind us that grasping power’s pivotal role in any economy is crucial for understanding economic conditions as well for developing strategies for advancing values like liberty and rule of law. Therein lies, I’d suggest, a lasting ordoliberal legacy of particular importance for our time: one in which, alas, most of the left and parts of the right have apparently forgotten the importance of such things for economies that serve relatively powerless consumers rather than very powerful vested interests.

– May 9, 2022

Should the Fed Devalue Our Currency to Implement Negative Interest Rates?

LAWRENCE H. WHITE

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Reprinted from *Alt-M*

In a thought-provoking article published by the IMF in April, Ruchir Agarwal and Miles Kimball argue for moving away from a “paper money standard” and toward an “electronic money standard.” The promised benefits include shorter recessions and lower average inflation. These benefits are said to result from eliminating the “zero lower bound” to nominal interest rates, giving the Federal Reserve the power to cut nominal interest rates as far as it needs—even into negative territory—to spur recovery from a recession. Even if nominal interest rates are only 2 percent going into the recession, the Fed could cut rates by 5 percentage points (say), reaching -3 percent, if that’s what they think a prompt recovery requires. The ability to conduct a negative interest rate policy, Agarwal and Kimball (hereafter AK) argue, removes the need to have an inflation target well above zero in order to keep nominal interest rates high enough to allow 5 percentage points of rate-cutting. It thereby encourages the Fed to lower its inflation target from 2 percent to zero.

The “zero lower bound” is created by the unlimited availability of a zero nominal return on currency: nobody will accept significantly negative returns when they can always get a zero return (or more precisely, zero minus a small cost of storage) by holding Federal Reserve Notes. Think of the scene in *Breaking Bad* where Walter and Skyler White survey a room-sized storage locker where they are keeping millions of dollars in stacks of \$100 bills. A back-of-the-envelope estimate indicates that their storage costs were less than one-tenth of one percent per year. Under such conditions, the public

will not accept bond returns more than one-tenth of one percent per year below zero.

The “electronic money standard” the authors advocate is a novel kind of fiat dollar standard in which Federal Reserve Notes (the circulating paper part of the Fed’s monetary liabilities) would no longer always provide a zero return because they would no longer always trade 1:1 against bank reserves (the account-balance electronic part). AK note that it isn’t necessary to eliminate large denominations of paper currency (as some other proposals to enable a negative interest rate would, for example Kenneth Rogoff’s) to stop it from being a zero-nominal-return asset that sets a zero lower bound on nominal interest rates. It is only necessary to ensure that holding currency also pays a negative rate when the Fed pays a negative interest rate on bank reserves. When a negative interest rate on bank reserves is deemed necessary to fight recession, AK propose devaluing paper dollars against electronic dollars at a corresponding rate. If (for example) bank reserves pay -3% per annum, paper dollars are to lose their value at 3% per year against electronic dollars held on the books of the Fed (bank reserves) and on the books of the banking system (deposit balances).

AK do not spell out a specific mechanism in their 2022 paper for imposing a negative return on cash, but refer to a 2019 paper in which they consider several mechanisms. There they rate as the “first-best” policy one that “takes paper currency off par.” In essence, the Fed would announce and maintain a sliding peg between Federal Reserve Notes and bank reserves. When the policy rate is -3 percent per year, what is a “\$100 bill” at the start of the year will be convertible into (and purchasable with)

only \$97 of electronic dollars at year's end. Conversions on intermediate dates will fetch intermediate rates, so that "the paper currency smoothly depreciate[es] ... over the course of the year." There is no limit on the Fed's ability to enforce its chosen exchange rate because it can issue or buy back Federal Reserve Notes in unlimited quantities. Private-sector businesses and individuals will discount paper currency at the rate their banks discount it for deposits, and their banks will discount it at the rate the Fed discounts it in exchange for bank reserves.

The AK proposal usefully shows that eliminating the zero lower bound can be separated from eliminating large-denomination paper currency and the financial privacy it provides. It also usefully makes the point that a positive secular inflation rate is not necessary to make room for anti-recession policy.

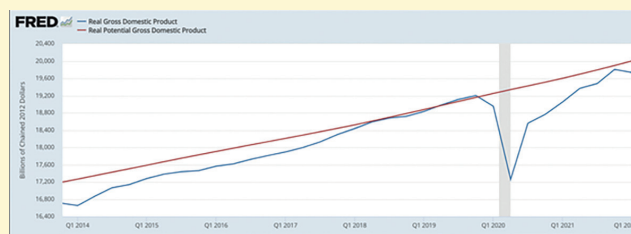
Assuming that we retain a fiat dollar, would enacting the AK proposal make the public better off? That is, would the typical dollar-holder benefit from enabling the Fed to impose negative returns on dollars in all forms? The answer isn't *obviously* no. Note that a 2 percent average dollar inflation rate (the Fed's currently declared target) already imposes a -2 percent average *real* return on dollar currency holders. If (as AK hope it would) enabling negative interest rate policy in this way really would lead the Fed to lower its non-recession inflation target to zero percent from 2 percent, and a negative nominal rate on currency would be imposed less than half the time, the program might actually raise the average expected real return on holding U.S. currency.

Such a program would be dominated, however, by a program of lowering the inflation target to zero and combatting recessions in an equally effective alternative way that does not require negative nominal rates, *if* such an alternative way were available. (A plausible alternative will be discussed momentarily.) Judged by that benchmark, the devaluation of paper currency is a welfare-reducing tax on currency,

compared to currency that holds its value in the unit of account. I have written before about the dubious wisdom of punishing money-holders in order to escape the zero lower bound.

AK's proposal thus promises to improve money-holders' welfare only if (1) it actually results in a lower combination of (inflation + negative nominal own-return on money) on average, or, failing that, (2) negative interest rate policy is so much more effective at recession-fighting than the alternative that its benefits exceed its burden on money-holders. The second has not been shown, and may be considered doubtful. Note that the U.S. economy has just recovered rapidly from a sharp recession without cutting interest rates below zero, and without cutting them more than 1.5 percentage points. The Fed's policy instrument of interest on reserve balances was 1.6 percent on 1 February 2020, the eve of the pandemic recession of 2020, fell to 0.1 percentage points over the next six weeks, and remained there for the next 15 months. Real output plunged for the first two quarters of 2020, then recovered its losses in the level of real GDP over the next four quarters, and even closed the gap to 99.5 percent of the full-employment or "real potential GDP" growth path over the following two quarters (see Figure 1).

Figure 1: Real GDP and Real Potential GDP, 2014-2022.



Granted, this was an atypical recession and recovery. The point I seek to make in citing it is only that prompt recovery is at least sometimes *possible* without a deep cut in the Fed's interest-rate instrument. The broader point I want to make is that,

under alternative policy procedures, counter-cyclical monetary policy *does not require the Fed to use an interest rate instrument at all*. The class of Taylor Rules, which specify the proper value of an interest rate target or instrument as a function of current macro data, does not exhaust the set of viable monetary policy rules with recovery-supporting feedback from current macro data.

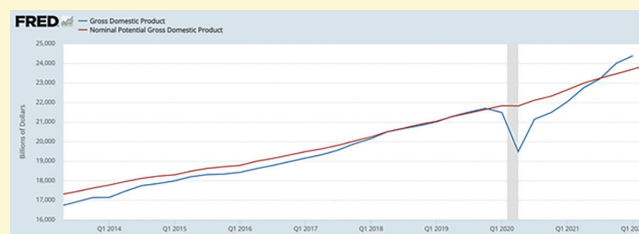
The macro economist Bennett McCallum (2000) long ago formulated a feedback rule for using the monetary base—the degree of quantitative easing—as an instrument to target the path of nominal income. Under the McCallum Rule procedure, the Fed varies the rate of growth of the monetary base in response to the moving-average rates of growth of base velocity and real income, without feedback from interest rates. Until 2015 the monthly St. Louis Fed publication *Monetary Trends* tracked whether monetary base growth was currently above or below a range of McCallum Rule prescriptions, just as it also tracked whether the Fed Funds rate was above or below a range of Taylor Rule prescriptions. Unlike a Taylor Rule, a McCallum Rule does not require using an interest rate target or instrument. It does not require an estimate of the real natural rate of interest, which is a well-known problem in implementing a Taylor Rule. It is agnostic about the role of interest rate changes in monetary policy transmission.

The intuition behind the effectiveness of using the monetary base as the policy instrument is straightforward, although unfortunately less familiar today than the logic of IS-LM and the Taylor Rule. It begins with considering it an appropriate goal for fiat monetary policy to avoid creating or prolonging a monetary disequilibrium, meaning an excess supply or demand for money balances by the public at the current price level. (This theme was central to the work of Leland B. Yeager and the late Axel Leijonhufvud, who emphasized that

recessions characterized by an aggregate excess supply of non-money goods are logically equivalently characterized by an excess demand for money balances.) To minimize monetary disequilibrium, the system should expand the supply of fiat money in response to signs of an unsatisfied excess demand for money balances, and contract it in response to signs of excess supply.

In a closed economy, the central bank manages the supply of base money. Quantitative easing or tightening—open market purchases that enlarge the monetary base, or sales that shrink it—expands or contracts broader money in the hands of the public, supposing that the “money multiplier” remains the same (under the Federal Reserve’s current operating system, this requires that the interest rate on reserves that the Fed pays banks reserves tracks the risk-free rate that banks could earn on Treasuries). In 2020 the Fed quite properly acted to expand M2 in response to the spike in the demand to hold M2 balances, or in other words, in response to the plunge in M2 velocity. The expansion did not come soon enough to prevent nominal GDP from falling in 2020, but it was *more* than enough to restore nominal GDP to its pre-pandemic path by the end of 2021 and to push it well above that path in 2022 (see figure 2).

Figure 2: Nominal GDP and Nominal Potential GDP.



The McCallum Rule (McCallum 2000, p. 52), for readers who are unfamiliar with it, specifies the appropriate quarterly growth rate for the monetary base as

$$\begin{aligned}\Delta b_t &= \Delta x_t^* - \Delta v_t^a + \lambda (\Delta x_t^* - \Delta x_{t-1}), \\ \Delta x_t^* &= \pi^* + \Delta y_t^*\end{aligned}$$

where (all variables in logs) Δb_t is the quarter-over-quarter change in the adjusted monetary base, Δv_t^a is the moving-average change in base velocity over the previous 16 quarters, Δx_t^* is the target level of nominal GDP, Δx_{t-1} is lagged actual nominal GDP, and the parameter $\lambda = 0.5$. The rule (the first equation) prescribes that base money growth should offset base velocity growth shocks. And, if nominal GDP is undershooting its reference path, the Fed should loosen monetary policy by increasing the expansion of base money by half the discrepancy. The second equation says that the nominal income target Δx_t^* is the sum of the desired price level π^* plus the 40-quarter moving average of real GDP Δy_t^* . In sum, the rule stabilizes nominal GDP along a pre-determined path using a monetary instrument. McCallum calibrated the λ parameter and the moving-average lengths using various simulations, and found that the calibrated rule's counterfactual performance across a variety of macro models was better than the Federal Reserve's actual performance even during the Great Moderation.

AK take for granted that anti-recession monetary policy must work by cutting an interest rate target or instrument. They observe that “[b]efore zero lower bounds became a problem,” postwar central banks “typically cut nominal rates by 5 to 6 percentage points to restore the economy to its full potential.” But such a method of operation is not dictated by the structure of a monetary economy on a fiat standard. It derives from a self-imposed policy framework. In the pre-2008 monetary regime, the Fed used the Federal Funds rate as an intermediate target, which may be interpreted as a guideline for supplying the

quantity of money sufficient to meet the quantity of money demand at the desired price level. Switch from using an interest-rate-targeting procedure to using a monetary aggregate instrument, and it stands to reason that the “need” for cutting nominal rates by 5 or 6 percentage points to alleviate an excess demand for money disappears with it. To put the point another way, zero lower bounds are “serious obstacles to monetary policy,” as AK put it, only insofar as monetary policy is conducted using an interest rate as its instrument or intermediate target. Where AK comment that the zero lower bound “is not a law of nature, but a policy choice,” I suggest that the same is true about the need to fight an excess demand for money by cutting an interest rate instrument or target.

McCallum (1989) provided some evidence that a Taylor Rule (during a period in which the zero lower bound is not binding) is no more effective at mitigating recession than a McCallum Rule. If this finding is persuasive empirically (an update would be welcome) or theoretically, then it is hard to justify imposing the burden of negative interest rates on depositors and the burden of currency devaluation on currency-holders. For this reason, devaluing currency would rightly be highly controversial among members of the public—nearly as much as abolishing currency altogether.

– May 17, 2022

The Federal Reserve's Moving Target

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In recent years, the Federal Reserve moved to a new, flexible average inflation targeting regime. Under this regime, the Federal Reserve aims to ensure that inflation is 2 percent on average over time. This implies that the Federal Reserve will make up for periods of below average inflation with above average inflation, and periods of above average inflation with periods of below average inflation. This is in contrast to the Fed's previous policy, in which any past deviation of inflation from its target was not factored into policy going forward. While there are potential benefits to this approach, the Fed risks creating a moving target that generates additional volatility into the economy.

Central banks have instruments, intermediate targets, and goal variables. Instruments are the things that the central bank directly controls. These are things like the monetary base (currency and bank reserves), the discount rate, and interest on reserves. The Federal Reserve can adjust the monetary base and these interest rates directly. Goal variables are economic outcomes that the central bank wants to produce. In the US, the goal variables are the inflation rate and the unemployment rate, but the goals are vague: stable prices and full employment. Intermediate targets are variables that the central bank tends to have more control over than the goal variables and often are things that the central bank observes with greater frequency than the goal variables. These intermediate targets represent important links between the direct actions taken by the central bank (changes in the instruments) and the achievement of the central bank's goals. In other words, intermediate targets might have stable empirical relationships with the goal variables.

Thus, the central bank adjusts its instruments to hit a particular intermediate target that they think will produce its intended goals. These intermediate targets tend to be things like broader measures of the money supply or the federal funds rate.

All of this sounds complicated. However, this is why having a particular target for monetary policy is important. For example, if the Federal Reserve has a 2 percent target rate of inflation, the stance of monetary policy is clear. When inflation is above 2 percent, this is an indication that policy has been too loose. When inflation is below 2 percent, this is an indication that policy has been too tight. This provides feedback to the central bank, both in terms of their job performance and the reliability of their intermediate targets in producing their desired policy objectives.

This is why the Federal Reserve's shift to a flexible average inflation target raises important questions and concerns. One way to interpret this shift in policy is to consider it equivalent to price level targeting. Under a price level target, the central bank commits to a growth path for the price level. If the central bank wants the average inflation rate to be 2 percent, it could target a path for the price level such that the price level rises, on average, by 2 percent per year. If the value of the price index today is 100, this implies that the value of the index after two years would be 104. This could occur if inflation is 2 percent in each of those two years or if inflation is 1 percent the first year and 3 percent the next.

This is in contrast to a typical inflation-targeting regime in which any past deviation of inflation from its target is ignored in the future conduct of policy. Advocates of a price level target typically

consider a “let bygones be bygones” approach to policy suboptimal. They prefer that the central bank target a path for the price level because this creates a long-run commitment device and helps to stabilize inflation expectations. Under a typical inflation-targeting regime, persistent deviations from target push the price level further and further away from its expected path without any promise to return to that path. In the short run, these deviations from the path can be costly since some economic decisions were based on an incorrect path. Ultimately, expectations will adjust to the actual path, but the intervening period is potentially costly in terms of resource misallocation.

Some consider it an open question as to whether or not the flexible average inflation targeting regime is a price level target. However, Fed chair Jerome Powell seems to have indicated that it is not, saying:

In seeking to achieve inflation that averages 2 percent over time, we are not tying ourselves to a particular mathematical formula that defines the average. Thus, our approach could be viewed as a flexible form of average inflation targeting.

Perhaps this is simply unclear language, but it does not sound consistent with a price level target. With a price level target, there would be some clear indication about where the price level was headed over the long term; the only question is how long the transition period would be. Perhaps this is what Powell meant. However, if that is what he meant, then he should say so.

If flexible average inflation targeting is not equivalent to a price level target, then it is potentially a very destabilizing policy. As I just explained, the problem with the “let bygones be bygones” approach to a typical inflation-targeting regime is that there are potential misallocations due to persistent deviations

from target. Under a flexible average inflation-targeting regime in which the average is determined by discretion, the Federal Reserve is effectively aiming at a moving target.

If there is no formula for determining the average inflation rate, then how would one form expectations about the future path of the price level? This is a “let bygones be bygones” approach in which nobody knows what bygones will be forgiven. If the inflation rate is 4 percent one year, 3 percent the next year, and 2 percent the third year, what should one expect the inflation rate to be in the fourth year? The fifth year? With a price level target, there are a range of possibilities, but long-run expectations would dictate a return to the trend in the price level and therefore inflation rates below 2 percent for some period of time. Perhaps the central bank would return to the price level path. Or, perhaps the central bank would simply drop the inflation experienced in year one or year two from its calculation. Under a flexible average inflation target regime, what would happen in subsequent years is anyone’s guess.

The implications of the Federal Reserve’s decisions are important. If persistent deviations from its target can be costly in terms of resource misallocation, imagine the costs associated with simultaneous fluctuations in both inflation and the Federal Reserve’s target for inflation.

These concerns are not merely a theoretical possibility. Currently, inflation is considerably above the Federal Reserve’s 2 percent target. However, the long-run forecasts of the Federal Reserve predict a return to 2 percent inflation. There is no promise of inflation rates of lower than 2 percent at any point in the future. Adjust your expectations accordingly, if you can figure out how to do so.

– May 13, 2022

Rent Selling Countries are More Corrupt and Less Wealthy

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In the field of political economy in recent decades an important and valuable emphasis has been placed on “rent seeking,” defined as pressure groups lobbying for (and getting) special favors (bestowed on themselves) and disfavours (imposed on their rivals or enemies). It’s a key theme of “public choice” theorists, who tend to love free markets and constitutionally constrained states.

Rent seeking, however, is only the demand side of political favoritism; the less-emphasized supply side – call it *rent selling* – is the real instigator. Only states have the power to create zero-sum political favors, disfavours, and cronies. Cronyism isn’t a brand of capitalism, but a symptom of hybrid systems; interventionist states that heavily influence socioeconomic results actively invite lobbying by those who are most affected and can most afford it (the rich and powerful). But the root problem of favoritism isn’t one of demanders who bribe, but of suppliers who extort.

Cronyism is measurable today in well-devised metrics of political corruption. We also have good metrics on economic freedom, capturing degrees of intervention (and the extent of hybridness). The pattern is clear: Cronyism increases as a nation becomes less free economically, and with diminishing freedom a system moves away from capitalism (towards fascism or socialism).

Political favors and disfavours can be codified in regulation, taxation, and/or subsidization. Rent selling is akin to the long-acknowledged phenomenon of influence peddling. Political influence can only be peddled (sold) if it first exists. The creators and supply-siders of political favors and disfavours include politicians, policymakers, and

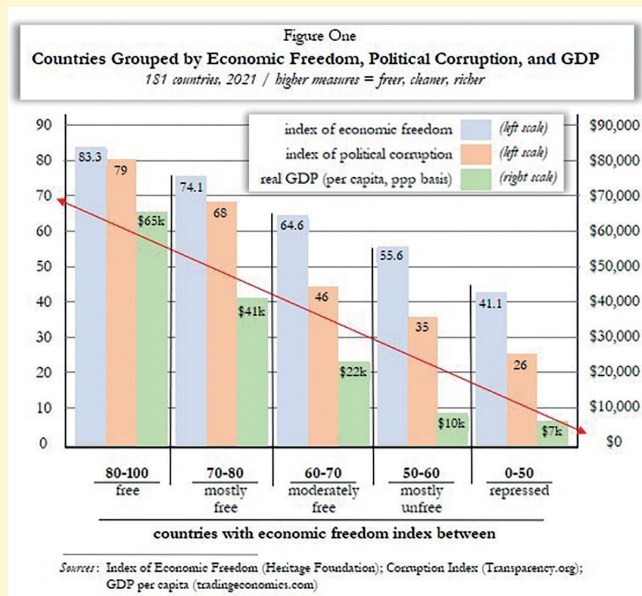
bureaucrats. Massive new sums of money are spent on politics, but that’s because so much politics is injected into money-making.

Political favors and disfavours count on an erosion and rejection of equality under the law. This principle, which for three centuries has preserved and protected legitimate rights, the inviolability of property rights, and the sanctity of free contracting, is crucial to the maintenance of a free, capitalist system. By now there should be little doubt that the rule of law in America is being eroded. Crises and emergencies, both real and contrived, are used as a pretext to rule arbitrarily, to mandate, decree, and dictate. This happened after the attacks of 9/11, after the financial crisis of 2008, and after the COVID-19 pandemic in 2020. Arbitrary, authoritarian political rule is also a bipartisan trend. Both Trump and Biden, for example, have invoked the Defense Production Act (1950), which gives Washington the power to seize and control whole industries, especially during war.

Whereas equality under the law requires equal treatment of all, opposite, unjust systems institutionalize differential, discriminatory treatment (whether legal or fiscal). That’s what is needed to bestow favors and impose disfavours—unequal treatment under law. Moreover, the more influential, powerful, and redistributive a government becomes, the less free its economy becomes, and the more likely its political corruption and economic stagnation tend to spread.

Figure One summarizes data from 181 countries around the world. I gather measures of their degree of economic freedom, political corruption, and per capita income. The relationships are clear. The freer a nation’s economy, the less politically corrupt it is, and the richer it is. In contrast, the less economically

free a nation, the more politically corrupt it is and the poorer it is.



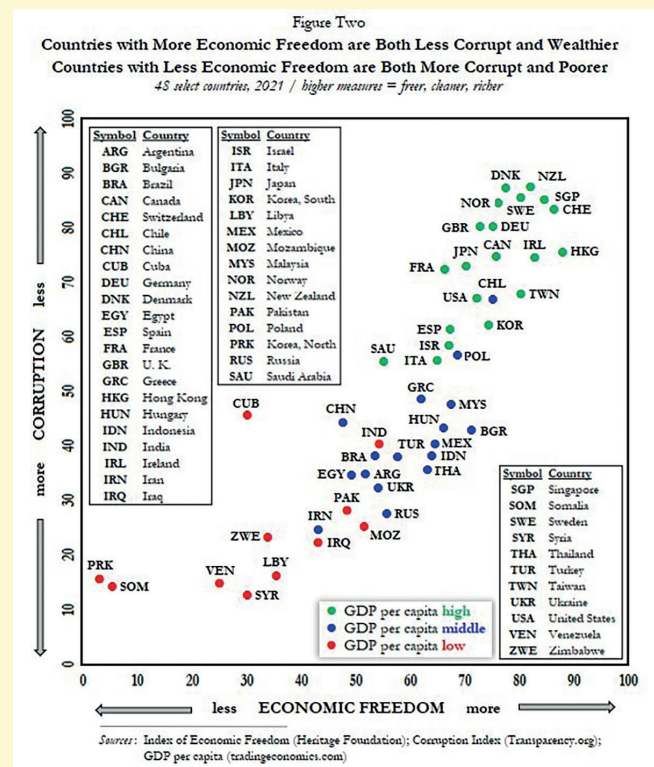
Correlation is not causation, of course; the data pattern in Figure One doesn't self-evidently prove whether political corruption (granting favors, imposing disfavors) is predominantly a supply-side or demand-side phenomenon, whether it originates and persists due to markets or to politics. But it's difficult to imagine why anyone in the profit-seeking private sector would waste their time, energy, or money seeking influence on the public sector, if it has little or no influence to offer in the first place. To "offer influence" is to peddle it, provide it, and supply it.

In my judgment, the causal sequences are thus: On the upside, more economic freedom (due to pro-capitalist ideology and hands-off public policy) leads to clean governance and more prosperity; on the downside, less economic freedom (due to anti-capitalist ideology and interventionist public policy) leads to political corruption, then less prosperity.

For government policy to erode economic freedom, it must regulate, trust-bust, tax, spend, and subsidize. The more it does so, the more it attracts the attention, lobbying, and funding of those most

affected (for good or ill). Political actors know this, but aren't so eager to advertise it loudly. They prefer to pose as selfless public servants, unavoidably victimized by rich and powerful "fat cats," by nefarious "special interests." In fact, many low-paid political actors envy the material success and wealth of real (private sector) producers, and aim to legally loot them.

Figure Two presents the same data but in a two-dimension exhibit using 48 of the 181 countries. As in Figure One, the freedom and corruption measures are positively related (upward sloping). Notice also that the richer nations (designated by green dots) reside in the northeast quadrant of the exhibit, while the poorer nations (designated by red dots) reside in the southwest quadrant.



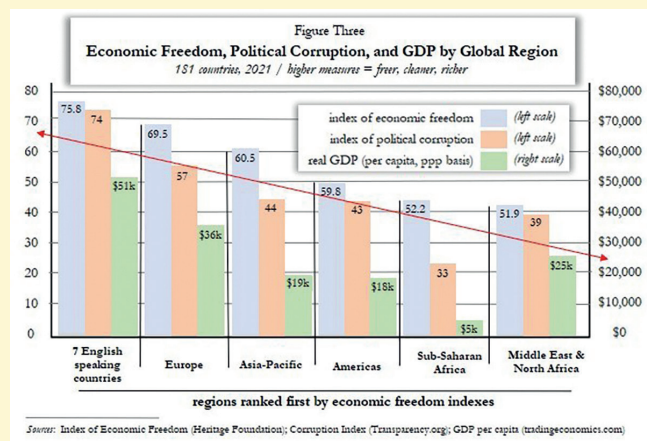
Richer nations are richer in large part because they are freer economically, but they are also less corrupt politically. Their property-protecting, pro-capitalist public policies prioritize the multiplication of wealth, not its division or diversion. Poorer

nations are poorer largely because they are less-free economically, and hence also more corrupt politically. Their property-violating, anti-capitalist policies divide and divert wealth instead of multiplying it.

We can also assess the metrics globally by geographic region. Figure Three illustrates how the seven biggest English-speaking nations enjoy the most economic freedom, less political corruption, and thus greater per-capita income. Next best are the nations of Europe, followed by those in the Asia-Pa-

cific region. the same ones who decry “crony capitalism.” But the phrase is worse than a blatant contradiction. It’s a ruse deployed to blame capitalism for the results of anti-capitalist policies. The real cronies are those who demand and supply interventionism. Despite their claims, they can’t get money out of politics, or reduce corruption, because they’re so eager to inject politics into money-making.

– May 13, 2022



The worst cases occur in the nations of Sub-Saharan Africa, known for their decades of cruel, anti-capitalist policies. They’ve prided themselves on being free (since the 1960s-1970s) of the colonization of European powers (mainly Britain and France), but most have only freed themselves from the rule of law, economic freedom, clean governance, prosperity, and humanity. Nations in the Middle East and North Africa are least free, and only a bit less corrupt than those in lower Africa. But to the extent they are richer than the three other regions, it’s mainly because sheiks seized the oil fields built by British, French, and American oil giants. They’ve since benefited from the Fed’s debasement of the dollar (thus appreciation in the value of their oil exports).

Those today who demand an increasingly interventionist-authoritarian role for the state are often

Income Distribution and Inequality

ROBERT F. MULLIGAN

Senior Fellow

Italian economist and engineer Vilfredo Pareto (1848-1923) conjectured that for any population, income naturally follows a log-normal distribution. The normal, or Gaussian distribution ranges from negative to positive infinity with a central mean. Because logarithms are always positive, the log-normal distribution ranges from zero to positive infinity with a positive mean, consistent with there being no upper bound for the highest incomes. Pareto's approximation describes the distribution of incomes within a country accurately except for the highest one to three percent. French-American polymath Benoit Mandelbrot (1924-2010) demonstrated that the logarithm of his fat-tailed Mandelbrot-Lévy or stable Paretian distributions model income well at all levels. This indicates that greater shares of overall income are received by the very wealthy individuals in the upper-tail of the income distribution (Figure 1).

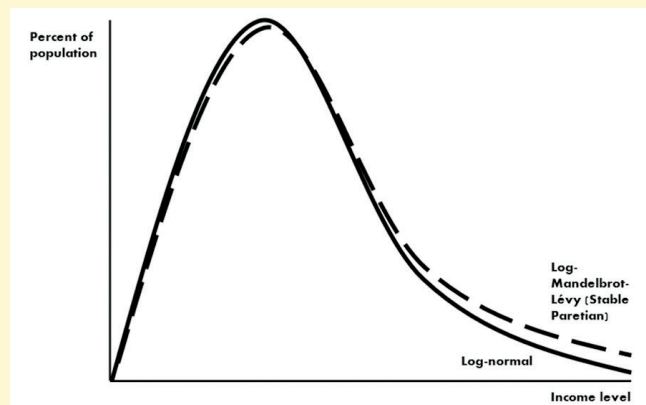


Figure 1. Log-normal v. log-Mandelbrot-Lévy probability distributions used to model income distribution.

American economist Simon Kuznets (1901-1985) suggested income inequality rises during the process

of industrialization but falls later, an observation formalized as the Kuznets curve (Figure 2). The rationale for the Kuznets curve is that the individuals who implement emerging technologies during early-stage industrialization initially capture most of the benefits of economic growth. Later, income inequality falls during later-stage industrialization as technological progress is diffused more broadly and raises worker productivity and wages throughout the economy. This has been observed generally for industrialized countries from about 1870.

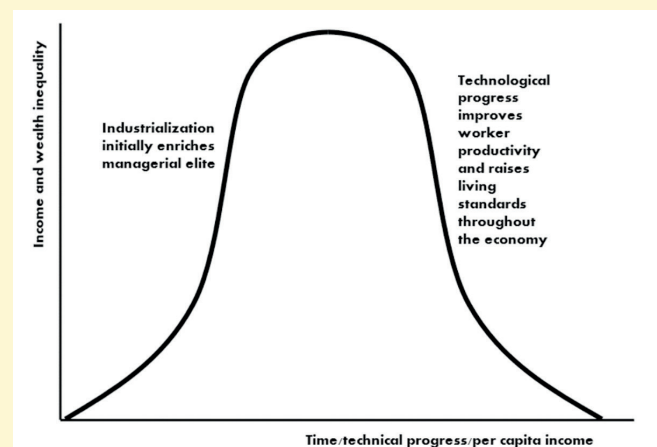


Figure 2. The Kuznets curve

Because pollution accompanies industrialization and disproportionately impacts the poor, the related concept of the environmental Kuznets curve also becomes relevant (Figure 3). Kuznets also observed that during the transition from an agrarian to an industrial economy, not only does income become increasingly concentrated, but pollution and natural resource depletion occur at accelerating rates. As industrialization and technical progress increase wealth, albeit unequally, life expectancy and the

population also increase. The larger population further contributes to economic activity, but also to pollution emissions, resource depletion, and environmental degradation. However, once a society attains a certain level of affluence and well-being, environmental impact becomes sufficiently recognized, triggering anti-pollution regulations and a shift toward less environmentally damaging practices and technologies. Environmental quality then starts to improve as later-stage industrialization proceeds, the society continues to progress both culturally and economically, becomes even wealthier, and can now afford to focus on alleviating and remediating environmental impacts.

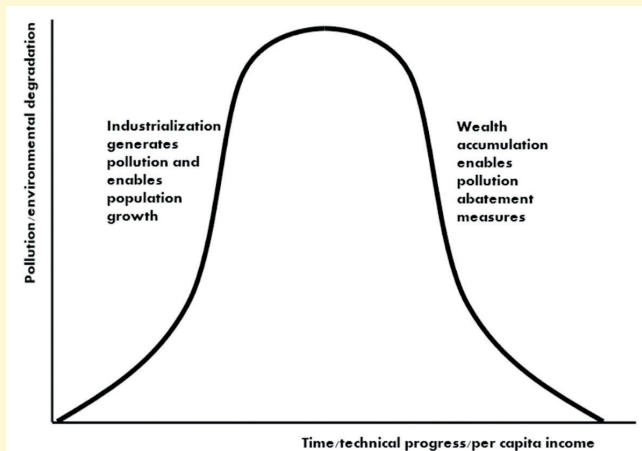


Figure 3. The environmental Kuznets curve

How public policy approaches income inequality depends on whether it is viewed as a value-neutral empirical observation, or as resulting from a pernicious failure of social justice. The first does not call for a public policy response, but the second does. Furthermore, the appropriate response should not be aimed at alleviating income inequality per se, but must also consider whether the causes of inequality are inherently unjust, as only unjust causes can justify correction through policy, regulation, or legislation. Income inequality arises naturally because

talent, entrepreneurial awareness, aesthetic sensibilities, technical knowledge, physical strength, work ethic, etc., vary naturally from one person to the next. Individuals who possess or acquire abilities enabling them to produce greater value for others in society should be rewarded for it through free exchange, otherwise there will be no incentive to benefit others, or reward for doing so.

It thus becomes important to distinguish between sources of inequality that are morally objectionable and those that are not. For example, enslaved people provided their owners significant income without benefiting themselves. Even after emancipation, formerly enslaved people still faced many decades of structural discrimination where their rights to their own income and property were not equally protected either *de jure* or *de facto*. Even enslaved people who had acquired technical skills, e.g., as blacksmiths, mechanics, mariners, technicians, etc., generally lost access to the capital equipment they were trained to use. Though they might retain the technical knowledge, a recently-emancipated blacksmith still faced the burden of acquiring the equipment and tools needed to practice his trade. This barrier must be overcome for his income to rise above the value of his physical labor alone.

Furthermore, most enslaved people would have acquired more education, training, and capital equipment than they were permitted to before emancipation, and in many cases discrimination continued to prevent them from doing so for long afterward. An individual's place in the income distribution does not generally persist from one generation to the next unless underlying structural limitations also persist, e.g., institutional discrimination, which can potentially be addressed through public policy.

The most common arguments against income inequality fail to consider whether it has arisen through rewarding growth-enhancing productive

activities which benefit the whole of society, or from unproductive rent-seeking which holds back worker productivity and economic growth. Rent-seeking is the pursuit of income based on legal-institutional inefficiencies. One form of rent-seeking occurs when an industry lobbies the government for subsidies, favorable tax treatment, restrictive licensing, or regulation which prevents or suppresses competition, providing the protected industry monopoly profits at the expense of their customers.

These measures provide the lobbying organizations and industries additional income, without their having to produce any added value for society. Rent-seeking shields less productive organizations from competition and enables them to extract higher prices from the public. Rent-seeking organizations also use bribery and political contributions to encourage elected officials and unelected bureaucrats to maintain a legal-institutional environment that shields them and their product from competition, and enables them to charge higher prices. Rent-seeking may raise incomes within the privileged organization or industry, but this can only come at the expense of others in society. Such non-productive rent-seeking calls for reform of the perverse legal-institutional environment so that rent-seeking is not rewarded or encouraged.

Inflation is another cause of income inequality, since higher-income households generally borrow more and are less likely to default on their loans. Inflation enables them to repay their loans with money of lower purchasing power, transferring wealth from lenders to borrowers. A lower percentage of low-income households benefit from inflation through borrowing, and those that do generally benefit to a lesser extent than high-income households. Thus, one of the most important policies the government could enact to lessen income inequality would be to lower or eliminate inflation.

Invariably, however, the proposed solution to any form of income inequality has been an

indiscriminate and highly punitive progressive tax on all income and wealth, regardless of how it was earned. Unfortunately, such a broad and indiscriminate tax further diverts resources and talent toward unproductive rent-seeking. Note further that the evidence of income inequality employed to justify such measures generally relies on flawed measures which ignore the impact of progressive taxes and transfer payments, both of which act to alleviate existing income inequality. This purported solution of punitive tax policy is invariably worse than the problem it was designed to solve.

– May 16, 2022

Let's Cancel Student Loans – Not Forgive Them, But Cancel the Program

GEORGE LEEF

Contributor

In recent weeks, the tumult in Washington has largely centered on the issue of student loans. Almost every Democrat and left-leaning pundit has come out in favor of some degree of relief for those who have amassed debts to pay for college. Rep. Ro Khanna (D-CA) for example, penned a *Washington Post* opinion piece with the exhortative title, “President Biden, it’s time to cancel student debt.”

What he wants the President to do is to forgive students of their payment obligations under their federal student loan contracts. It’s highly questionable whether the President has the legal authority to unilaterally forgive student debts, but let’s put aside that problem.

I’m going to argue that Congress should do something it unquestionably has the power to do, namely to repeal a statute. The statute is the Higher Education Act (HEA) of 1965, one of the many laws passed by a giddy Congress at the behest of President Lyndon Johnson. Johnson had a host of ideas for improving America through federal money and regulation—his “Great Society”—and government meddling in education was at the top of his list. Title IV of the Act created the federal student loan program.

The first question that ought to have been raised is whether the HEA was constitutional. Nothing in the Constitution authorizes Congress to legislate with respect to education. Article I, Section 8 sets forth the powers of Congress and education is not included. Education was among the great number of subjects that the Founders thought belonged to “the States or the people respectively” as the Tenth Amendment reads.

Nor does the Constitution anywhere authorize Congress (or the President) to lend money to college students—or to any other group.

If someone had asked James Madison or Benjamin Franklin or any of the other men who drafted the Constitution if it gave the new government the authority to lend money to people who wanted to go to college, the answer would have been an emphatic “No.”

Unfortunately, constitutional questions about federal programs were not being asked in the 1960s. A long series of Supreme Court decisions dating from the mid-1930s on had made it clear that the Court wouldn’t bother with challenges to federal spending and regulation. The “progressive” Justices had given broad interpretations to the General Welfare Clause and the Commerce Clause so that the intended restrictions of Article I, Section 8 were erased.

That’s too bad, because the federal student aid program has turned out to be one of the greatest blunders in our history, right up there with the income tax, the establishment of the Federal Reserve, and the pro-union National Labor Relations Act. It is responsible for the enormous increase in the cost of higher education, a vast throng of poorly prepared and disengaged students entering college, the consequent decline of academic standards, credential inflation (i.e., the requirement by many employers that applicants have college degrees if they want to be considered), and the statist drift of the country, as more and more of the citizenry has been subjected to the proselytizing of zealous faculty and administrators.

If we could take a time machine back to 1965 and show the legislators and voting public what the HEA would do, I think that it would not have been enacted.

Returning to the student debt “crisis,” it too is an unintended consequence of the HEA. It isn’t

really a crisis, since most student debtors are able to handle their payments, but there are some true horror stories—students with six-figure debts who can't even pay the mounting interest. Nevertheless, the burden of paying for very expensive college credentials that many students didn't really want and don't use in their work is a big economic drag.

What is the solution?

It certainly is not to decree a general forgiveness of college loan debts. That would do nothing to alleviate the problem of too many people attending too expensive colleges to obtain degrees of too little utility. It would, however, confer a great windfall on many heavily indebted graduates who have high-paying jobs in law, medicine, and other professions. They can and should pay off their loans.

A better solution that some people have advocated is to once again allow graduates who find themselves drowning in debt to have their student loan debts discharged in bankruptcy. That was permissible until 2005, when Congress decided to revise the bankruptcy law so as to make student loan debts extraordinarily difficult to escape.

Writing in the May 10 *Wall Street Journal*, Richard Schinder correctly observes, "Comprehensive student debt forgiveness is bad public policy. A legal regime—the federal bankruptcy system—already exists for those who truly need debt relief, with rules and consequences that are well-established."

If student loans could be discharged in bankruptcy, the worst horror stories would be addressed. I would favor that, especially if it were coupled with a requirement that if a student discharges his student loan debts in bankruptcy, the college or university that educated him (or at least took his money in exchange for various courses) would have to cover the loss to the taxpayers. That would make schools think long and hard before they admitted academically weak students who can only make it through

by taking raft of Mickey Mouse classes.

Those changes would go far toward alleviating the student loan mess, but they wouldn't solve it. Federal student aid money would continue to prop up needlessly high tuitions and lure many marginal students into college because the financing is easy.

The solution is to eliminate federal student aid funding entirely. (And yes, I would include college assistance for military veterans.) The HEA repeal bill might be written so that five years after the date of enactment, all federal loans and grants would cease, thereby giving students and institutions time to adjust. Alternatives such as Income Share Agreements (where funders provide most or all of the money the student needs for college in exchange for a contractual commitment obligating the student to repay a percentage of his earnings for some years after graduation) would emerge. Colleges would find many ways to shed costs that add little or no educational value, like "diversity" offices.

Higher education in the US is bloated and dysfunctional because federal meddling turned it into a mass entitlement. Turn off the federal spigot and it will rapidly improve.

– May 20, 2022

The Folly of Debt Cancellation

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It is now two-and-a-half months since Russia invaded Ukraine. With Russia's failure to take Kyiv, an international flow of weapons streaming into the hands of Ukraine's military forces, and losses mounting on both sides, the probability of a prolonged conflict is increasing. Economic costs are already staggering on both sides, considering the expenses of modern warfare and the interruption of trade. Russia, on top of that, has been hit by the most punishing raft of sanctions and penalties on record. Ukraine's economy is contracting rapidly, and its infrastructure will take years if not decades to rebuild.

At the start of the invasion in February 2022, Ukraine was a heavily indebted nation. Its \$129 billion in external debt was a considerable financial burden before Russian tanks were rolling down highways. Now, with an invasion underway, the \$14 billion scheduled to be paid back by the end of 2022 looks increasingly unlikely. Default, always within the realm of possibility, is becoming increasingly likely.

Accordingly, a handful of interests are now agitating that Ukraine's creditors (which include intergovernmental organizations, governments, and private lenders) either restructure, delay payment on, or cancel Ukraine's outstanding debt outright. Each of those options introduces a degree of moral hazard. Each also presents trade-offs: between lenders and borrowers, public and private interests, and the allocation of resources in the present versus the future. But in any event, forgiveness of debt in part or whole tends to be an awful idea, regardless of the circumstances.

To the extent that creditors of heavily indebted nations are representative democracies like the

United States, the idea that a government can lend taxpayer dollars only to summarily relieve debtors of their (voluntarily-incurred) obligation is anathema. Many will say that, for better or worse, once a government is in receipt of tax revenue, it may spend that money at its sole discretion. But erasing foreign debt amounts to a direct wealth transfer from US citizens to foreign states.

Worse yet are recommendations from activist groups that governments "protect" foreign debtors from private creditors within their borders. Typically the term "private creditor" refers to investment banks or other privately-owned financial institutions, including hedge funds. Whether that "protection" takes the form of a) governments pressuring banks to forgive debt outright, or b) governments paying private financial firms in lieu of what the debtor state would have remitted, there are costs.

In the former case, abrogating a private contract undermines private property rights and hinders the critical process of price discovery. In sovereign debt markets, a missed interest payment—while painful for the debtor, as defaults trigger higher borrowing costs and often result in an inability to access additional credit—typically results in a repricing of all debt in similar categories. That repricing sends signals to both lenders and borrowers in sovereign and other (corporate, municipal, etc.) debt markets which facilitate the reassessment of risk exposure and the consequent allocation of resources. In the latter case, a government "protecting" a debtor by paying a private firm in lieu is a gross misuse of taxpayer funds: here, not only protecting a foreign government, but offsetting the risk incurred by a private firm with taxpayer funds. And, as in the

former case, withholding critical pricing information from debt markets.

Wiping away a sovereign debtor's obligations, especially under circumstances such as in Ukraine, additionally creates the potential for perverse incentives. Unlikely though it is, a heavily indebted nation may, knowing of the possibility, instigate conflict to lobby for debt forgiveness in part or whole.

There is also an ideological angle to many of the debt relief/debt forgiveness proposals. Because debt restructurings are frequently tied to economic reform stipulations, including increased privatization requirements and reduced protectionism, full cancellation is viewed as preferable to accommodating "neoliberal" concessions. (This ties to other left views by which debt is fundamentally "illegitimate" or "predatory.")

Instantaneously vacating foreign debt, regardless of the circumstances, would immediately contract the debt market. Some market participants would withdraw indefinitely; others would either scale back their lending activity or increase the cost of loans, lifting not only the price of incurring new debt but the interest rate on outstanding debt. The knock-on effects would impact many debtors and creditors, private firms as well as governments and the citizens of those nations.

William Easterly of New York University (and a former World Bank economist) wrote of the assertion that high levels of debt are responsible for increasing destitution in developing nations, necessitating cancellation. First, he notes that between 1980 and 1999 most developing nations for which debt service (interest payments) became difficult to bear simply received new loans, with "new lending ... more than cover[ing] debt service payments on old loans." Further, Easterly reminds advocates of debt cancellation that citizens of nations don't owe other countries, their governments do. And economic hardship owes not to massive debt, but rather to

policy choices. Just as incurring debt doesn't create prosperity, wiping clean the slate of debt doesn't foster economic growth, expand trade, increase efficiencies, or bring about increased productivity. With or without debt, prosperity is a matter of sound policies; subsidies, redistribution, and corruption are vastly more likely to create poverty than indebtedness in and of itself.

To proponents, debt cancellation promises a renewal. Implicit in the suggestion is that debt is essentially an imaginary construct or shared delusion which, once onerous, can be jettisoned without consequences. This is underhanded and economically disingenuous. In fact, a loan is capital, extended in contemplation of opportunity costs. A lender forgoes use of extended funds taking into account the expected interest payments received over the term of the loan, and finally repayment of principal. Impaired loans, defaults, and restructurings induce repricings, which in turn spur reassessments on the part of creditors and debtors. The credibility of market participants, as well as the information content of interest rates, risk premia, and other prices in debt markets, requires the consummation of bona fide transactions.

So what can be done? For nations already encumbered by debt, whether relative to GDP or by some other measure, there is always renegotiation. Debt restructurings, though, are no panacea. They tend to result in short-term relief for beleaguered borrowers, but often only delay the inevitable. Only sound and timely economic policy choices pave the way for growth. And the nuclear option, repudiation/default, brings losses for all involved. While private firms may choose to lend to states of questionable creditworthiness at their own risk, governments would be better off staying out of the business of lending taxpayer funds to other nations. If already outstanding, whether the debtor is under duress or simply obstinate, the terms of the debt

agreement should be held sacrosanct. Discharging foreign debt undermines financial institutions, distorts prices, redistributes resources, and impairs the integrity of all parties. It also risks becoming the default practice, as political choices undertaken under exigent circumstances all too frequently do.

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