

RESEARCH REPORTS

Volume LXXXIII

October 2022

published by

AMERICAN INSTITUTE *for* ECONOMIC RESEARCH

RESEARCH REPORTS

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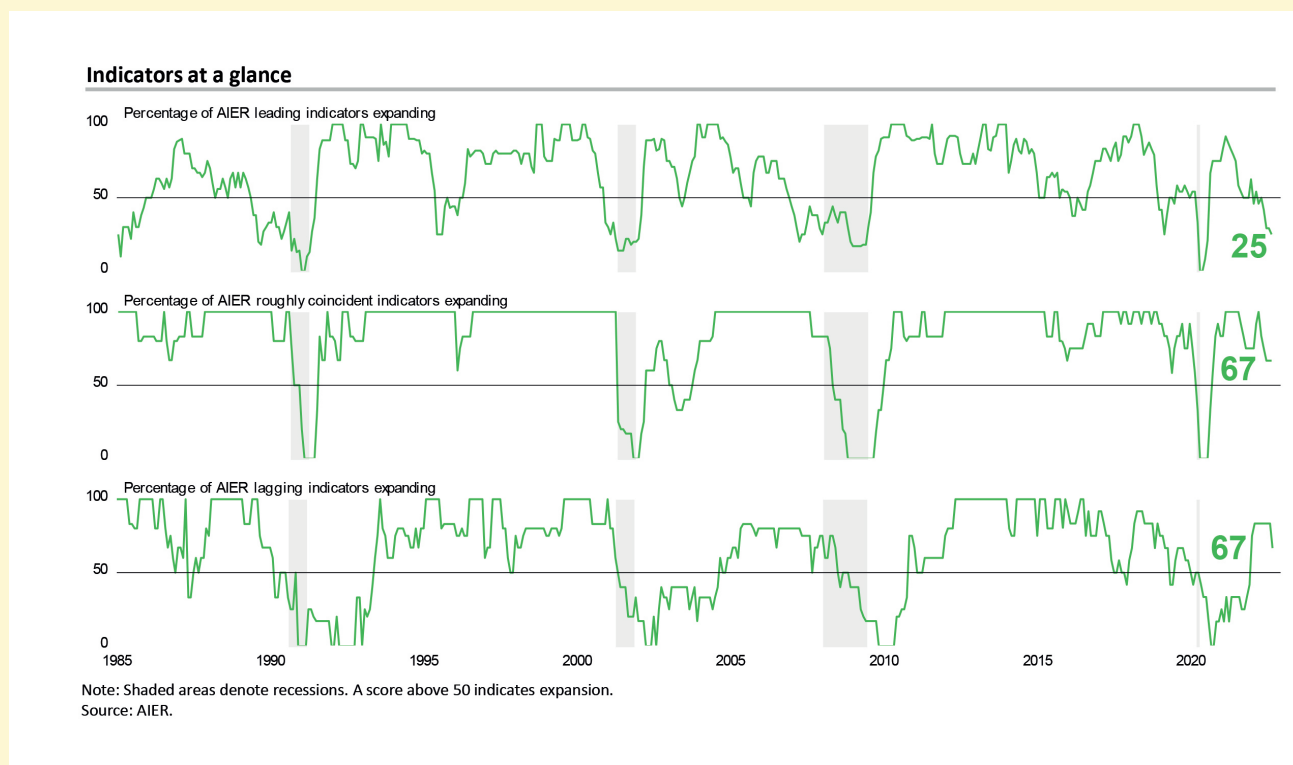
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BUSINESS
CONDITIONS
MONTHLY

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AIER Leading Indicators Index Falls Farther Below Neutral



Summary

AIER's Leading Indicators Index fell to a new cycle low of 25 in September from 29 in August. The latest result is the fourth consecutive month below the neutral 50 threshold and, excluding the lockdown recession in 2020, matches the lowest level since the recovery from the recession of 2008-2009. The September reading is consistent with broadening weakness in the economy and significantly elevated risks for the outlook.

Recent data has, on balance, suggested that economic activity is slowing significantly. Industrial activity as well as manufacturing-sector surveys were soft, suggesting weak growth and rising concerns about future demand. Real new orders for capital goods were likewise soft, trending essentially flat in recent months. None of these data suggest an imminent collapse. On the other hand, housing activity has fallen sharply despite an uptick in the latest month, and homebuilder sentiment is plunging. For the labor market, the August jobs report showed slow growth in private payrolls and a jump in the unemployment rate. The August Job Openings and Labor Turnover report indicated the number of job openings in the private sector fell sharply and layoffs rose. Finally, real core retail sales rose slowly through August, and September unit auto sales remained depressed.

Persistently elevated rates of price increases have resulted in an aggressive Fed tightening cycle. Both weigh on consumer and business attitudes, increase uncertainty, and restrain growth in activity. The longer elevated rates of price increases continue and the higher the Fed raises interest rates, the higher the probability that a vicious cycle of declining economic activity and contracting labor demand will begin to dominate the economy. Overall, the outlook remains highly uncertain. Caution is warranted.

AIER Leading Indicators Index Falls to 25 in September, Signaling Major Risks

In the latest update, the AIER Leading Indicators index fell to a new cycle low of 25. The September result is down 67 points from the March 2021 high of 92. Excluding the lockdown recession of 2020, matches the lowest level since the recovery from the 2008-2009 recession. In recent business cycles, the Leading Indicators Index has fallen into the twenties-range five times since 1985. In four of those instances, a recession followed within about 12 months. The exception was in 1995 when no recession was declared, but real GDP growth slowed significantly. With the latest reading falling farther below the neutral 50 threshold, the AIER Leading Indicators Index is signaling broadening economic weakness and significantly elevated outlook risks.

Three leading indicators changed signal in September. The initial claims for unemployment insurance indicator changed from a neutral trend to an unfavorable trend. As noted in previous reports, weekly initial claims had begun a rising (unfavorable) trend in mid-March. Though initial claims have started to decline again, an uptrend (unfavorable) is in place. Overall, initial claims remain very low by historical measures.

The real new orders for consumer goods indicator weakened from a positive trend to a neutral trend in September. Given the poor performance of real core retail sales and rising inventories, it's not surprising to see new orders fade.

Partially offsetting the weakening in the initial claims for unemployment indicator and the real new orders for consumer goods indicator was an improvement in the unit heavy truck sales indicator. One month after weakening to a neutral trend, the total heavy truck unit sales indicator reversed course, rising to a favorable trend. Heavy truck unit sales remain relatively high by historical comparison though they are below prior peaks.

The three indicators that changed signals this month were the same three that changed signals last month. It is not unusual for an indicator to fluctuate around inflection points, suggesting that the signals from each indicator may be volatile in coming months. Among the 12 leading indicators, just two remained in a positive trend in September while eight were trending lower, and two were trending flat or neutral.

The Roughly Coincident Indicators index held steady in September, coming in at 67 for the third consecutive month. Before July, the indicator posted a 75 in June, 83 in May, and a perfect 100 in April. Two indicators had offsetting changes last month. The real personal income excluding transfers indicator fell from a positive trend to a neutral trend while the Conference Board Consumer Confidence in the Present Situation indicator improved from a negative trend to a neutral trend.

In total, three roughly coincident indicators – nonfarm payrolls, employment-to-population ratio, and industrial production, were trending higher in September while one – the real manufacturing and trade sales indicator – was in a negative trend, and two – the Conference Board Consumer Confidence in the Present Situation indicator and the real personal income excluding transfers indicator – were in flat or neutral trends. Given the weakening in the AIER Leading Indicators Index, it would not be surprising to see declines in the Roughly Coincident Index in the coming months.

AIER's Lagging Indicators index declined to 67 in September after holding at 83 for seven consecutive months. Two indicators changed trend for the month. The composite short-term interest rates indicator and the 12-month change in the core Consumer Price Index indicator both fell from positive trends to neutral trends. In total, three indicators – the duration of unemployment indicator, the real manufacturing and trade inventories indicator, and the commercial and industrial loans indicator – were in

favorable trends, the composite short-term interest rates indicator and the 12-month change in the core Consumer Price Index indicator were neutral, and one indicator, real private nonresidential construction, had an unfavorable trend.

Overall, the AIER Leading Indicators Index fell farther below neutral in the latest month, signaling broadening economic weakness and sharply elevated levels of risk for the outlook. The economy is facing significant headwinds from elevated rates of price increases and an aggressive Fed tightening cycle. For now, the preponderance of data suggests slowing growth or mild contraction but no collapse (except for housing). Particularly important for the outlook is the strength of the labor market. A deeper and sharper contraction becomes more probable if significant declines begin to occur. Fed policy is likely to be a key factor in the progression of the labor market. Furthermore, the fallout from the Russian invasion of Ukraine and periodic lockdowns in China continue to boost uncertainty. Caution is warranted.

September Manufacturing-Sector Survey Suggests Weakening Activity and Less Intense Price Pressures

The Institute for Supply Management's Manufacturing Purchasing Managers' Index fell to 50.9 percent in September, barely above the neutral 50 level. September is the 28th consecutive reading above fifty, but the lowest since May 2020.

Several key component indexes were also close to or below neutral in September, including the new orders index, the production index, the new export orders index, the prices-paid index, and the supplier deliveries index. According to the report, "The U.S. manufacturing sector continues to expand, but at the lowest rate since the pandemic recovery began. Following four straight months of panelists'

companies reporting softening new orders rates, the September index reading reflects companies adjusting to potential future lower demand."

The new orders index fell by 4.2 points to 47.1 percent in September, the third reading below neutral in the last four months. The result suggests orders contracted again in September. The new export orders index, a separate measure from new orders, remained below neutral at 47.8 percent versus 49.4 percent in August. The latest reading is the second consecutive month below neutral.

The Backlog-of-Orders Index came in at 50.9 percent versus 53.0 percent in August, a 2.1-point fall. This measure has pulled back from the record-high 70.6 percent result in May 2021 but has been above 50 for 27 consecutive months. The index suggests manufacturers' backlogs continue to rise, but the pace is quite weak.

The Production Index registered a 50.6 percent result in September, gaining 0.2 points from August. The index has been above 50 for 28 months but remains very close to neutral.

The Employment Index fell sharply in September, falling back below the neutral threshold. The 48.7 percent reading suggests payrolls contracted in the manufacturing sector in September. The report states, "Labor management sentiment shifted in September, with a higher number of panelists' companies pausing hiring through hiring freezes and allowing attrition to reduce employment levels. Turnover rates eased, with 28 percent of comments citing backfill and retirement issues, a decrease from 33 percent in August." Among the six big sectors in the survey, only two reported expanded payrolls in September.

The Bureau of Labor Statistics' Employment Situation report for September is due on Friday, October 7, and expectations are for a gain of 250,000 nonfarm payroll jobs, including the addition of 20,000 jobs in manufacturing.

Customer inventories in September are still considered too low, with the index coming in at 41.6 percent, up 2.7 points from August (index results below 50 indicate customers' inventories are too low). The index has been below 50 for 72 consecutive months. Insufficient inventory is a positive sign for future production.

The supplier deliveries index registered a 52.4 percent result in September, down 2.7 points from August and the lowest reading since December 2019. The index was at 78.8 percent in May 2021. The easing trend over the past 16 months suggests delivery lead times are slowing at a much slower rate.

The index for prices for input materials sank again, dropping another 0.8 points to 51.7 in September and is the sixth consecutive monthly decline. The index is down from 87.1 percent in March 2022 and is at the lowest level since June 2020. The result suggests price pressures have eased significantly. The report notes, "This is the second consecutive month the Prices Index registered below 60 percent, a level not seen since August 2020 (59.5 percent), and this is also the lowest reading since June 2020 (51.3 percent). Over the past six months, the index has decreased 35.4 percentage points, including a combined 26-percentage point plunge in July and August." The report adds, "The slowing in price increases is being driven by continued (1) relaxation in the energy markets, (2) softening in the copper, steel, aluminum and corrugate markets and (3) continuing sluggishness in chemical and plastics demand. Notably, 28.1 percent of respondents reported paying lower prices in September, compared to 26.7 percent in August."

The manufacturing sector is showing clear signs of weakness though not collapse. Risks remain elevated due to the impact of inflation, an aggressive Fed tightening cycle, and continued fallout from the Russian invasion of Ukraine.

Industrial Output Fell, but Manufacturing Output Rose Slightly in August

Total industrial production decreased 0.2 percent in August after increasing 0.5 percent in July. Over the past year, total industrial output is up 3.7 percent.

Total industrial capacity utilization decreased 0.2 points to 80.0 percent from 80.2 percent in July. The August utilization is above the long-term (1972 through 2021) average of 79.6 percent but well below the highs of the 1970s when it was above 88 percent.

Manufacturing output – about 74 percent of total output – posted a modest 0.1 percent gain for the month, the second consecutive increase and fourth in the last six months but also the smallest over that period. From a year ago, manufacturing output is up 3.3 percent.

Manufacturing utilization was unchanged at 79.6 percent, holding above its long-term average of 78.2 percent. However, it remains well below the 1994-95 high of 84.7 percent.

Mining output accounts for about 16 percent of total industrial output and was unchanged last month following three strong monthly gains. Over the last 12 months, mining output is up 8.4 percent.

Utility output, typically related to weather patterns and about 10 percent of total industrial output, fell 2.3 percent, with natural gas up 0.6 percent but electric down 2.9 percent. From a year ago, utility output is down 1.6 percent.

Among the key segments of industrial output, energy production (about 27 percent of total output) fell 0.4 percent for the month with gains in oil and gas well drilling unable to offset declines in primary energy production, consumer energy products, converted energy products, and commercial energy products. Total energy production is still up 4.7 percent from a year ago.

Motor-vehicle and parts production (slightly under 5 percent of total output), one of the hardest-hit

industries during the lockdowns and post-lockdown recovery, fell 1.4 percent after a surge of 3.2 percent in July. From a year ago, vehicle and parts production is up 10.2 percent.

Total vehicle assemblies rose to 10.48 million at a seasonally-adjusted annual rate. That consists of 10.16 million light vehicles and 0.31 million heavy trucks. Within light vehicles, light trucks were 8.38 million while cars were 1.78 million. Assemblies have risen sharply from the lows but remained at the bottom of their prior typical range.

The selected high-tech industries index gained 0.3 percent in August and is up 5.8 percent versus a year ago. High-tech industries account for just 2.1 percent of total industrial output.

All other industries combined (total excluding energy, high-tech, and motor vehicles; about 66 percent of total industrial output) was unchanged in August. This important category is 2.6 percent above August 2021.

Overall, industrial output was little changed in August. Manufacturing output gained despite ongoing labor shortages and turnover, rising costs and shortages of materials, and logistics and transportation bottlenecks.

Real Nondefense Capital-Goods Orders Remain in a Flat Trend

New orders for durable goods fell 0.2 percent in August, following a 0.1 percent fall in July and a 2.3 percent jump in June. Total durable-goods orders are up 9.2 percent from a year ago. The August decline puts the level of total durable-goods orders at \$272.7 billion, a still-high result by historical comparison.

New orders for nondefense capital goods excluding aircraft, or core capital goods, a proxy for business equipment investment, jumped 1.3 percent in August after increasing 0.7 percent in July and 1.0 percent in June. Orders are up 7.3 percent from a year ago, with the level at \$75.6 billion, a new record high.

However, rapid price increases have had an impact on capital goods orders. In real terms, after adjusting for inflation, real new orders for durable goods fell 0.6 percent in August following a 0.7 percent decline in July. Real new orders for nondefense capital goods – one of AIERs leading indicators – sank 3.2 percent after a 2.0 percent gain in July. Real new orders for capital goods are trending flat over the past year with the August level about equal to the mid-2021 level. Furthermore, real new orders for durable goods and real new orders for nondefense capital goods remain below their January 2000 level.

Five of the seven major categories shown in the durable-goods report posted a gain in August, in nominal terms. Among the individual categories, electrical equipment and appliances led with a 1.0 percent increase, followed by computers and electronic products with an 0.8 percent rise, primary metals orders with a 0.4 percent gain, machinery orders up 0.3 percent, and all other durables adding 0.2, percent.

On the downside for the major categories, transportation equipment fell 1.1 percent, and fabricated metals orders declined by 0.7 percent. Within the transportation equipment category, nondefense aircraft sank 18.5 percent following a 12.1 percent jump in July, defense aircraft jumped 31.2 percent, and motor vehicles and parts were up 0.3 percent. Every major category shows a gain in nominal dollars from a year ago.

Durable-goods orders have posted a strong recovery from the lockdown recession measured in nominal-dollars. However, after adjusting for price increases, real orders for durable goods are rising at a very slow trend growth rate. Nominal new orders for capital goods are also growing briskly but in real terms, the trend is flat.

New Single-Family Home Sales Jump in August, but Headwinds Intensify

Sales of new single-family homes bounced higher in August, jumping 28.8 percent to 685,000 at a seasonally-adjusted annual rate from a 532,000 pace in July. The August gain was only the second increase in the last eight months, leaving sales down 18.4 percent from the December 2021 level and 33.9 percent from the August 2020 post-recession peak. August sales are close to the 50-year average selling rate.

However, the surprising result is unlikely to be sustained in the coming months. The National Association of Home Builders' Housing Market Index, a measure of homebuilder sentiment, fell again in September, coming in at 46 versus 49 in August. That is the ninth drop and the second month below the neutral 50 threshold. The index is down sharply from recent highs of 84 in December 2021 and 90 in November 2020.

According to the report, "In another sign that the slowdown in the housing market continues, builder sentiment fell for the ninth straight month in September as the combination of elevated interest rates, persistent building material supply chain disruptions and high home prices continue to take a toll on affordability." The report adds, "In another indicator of a weakening market, 24% of builders reported reducing home prices, up from 19% last month. Builder sentiment has declined every month in 2022. Due to tightening monetary policy, mortgage rates increased above 6% last week, the highest level since 2008, which is pricing buyers out of the market. In this soft market, more than half of the builders in our survey reported using incentives to bolster sales, including mortgage rate buydowns, free amenities and price reductions."

All three components of the Housing Market Index fell again in August. The expected single-family sales index dropped to 46 from 47 in the prior month, the current single-family sales index was

down to 54 from 57 in August, and the traffic of prospective buyers index sank again, hitting 31 from 32 in the prior month.

In August, sales of new single-family homes were up in all four regions. Sales in the Northeast, the smallest region by volume, rose 66.7 percent, sales in the South, the largest by volume, rose 29.4 percent, sales in the West increased 27.5 percent, and sales in the Midwest rose 16.7 percent for the month. Over the last 12 months, sales were down in two of the four regions, led by a 24.0 percent fall in the West while sales were off by 21.9 percent in the Northeast. Gains from a year ago were seen in the South (10.4 percent) and in the Midwest (5.0 percent).

The median sales price of a new single-family home was \$436,800, down from \$466,300 in July (not seasonally adjusted), putting the 12-month average price at a record high \$435,000. Meanwhile, 30-year fixed rate mortgages were 6.29 percent in late September (and around 5.13 percent in late August), up sharply from a low of 2.65 percent in January 2021. The combination of high prices and rising mortgage rates reduces affordability and squeezes buyers out of the market.

The total inventory of new single-family homes for sale rose 0.4 percent to 461,000 in August, the highest since March 2008. That puts the months' supply (inventory times 12 divided by the annual selling rate) at 8.1, down 22.1 percent from July, but 24.6 percent above the year-ago level. Inventory and the months' supply remain very high by historical comparison. The high level of prices, elevated inventory, and surge in mortgage rates should continue to weigh on housing activity in the coming months and quarters. However, the median time on the market for a new home remained very low in August, coming in at 1.7 months versus 2.4 in July.

Private-Sector Job Openings Fell Sharply in August

The latest Job Openings and Labor Turnover Survey from the Bureau of Labor Statistics shows the total number of job openings in the economy dropped to 10.053 million in August, down from 11.170 million in July.

The number of open positions in the private sector decreased to 9.037 million in August, down from 10.065 million in July. August was the fourth decline in the last five months and the lowest level since June 2021.

The total job openings rate, openings divided by the sum of jobs plus openings, fell to 6.2 percent in August from 6.8 percent in July while the private-sector job-openings rate fell to 6.5 percent from 7.2 percent in the previous month. The August result for the private sector is the lowest since April 2021.

The industries with the highest openings are education and health care (1.885 million), professional and business services (1.872 million), trade, transportation, and utilities (1.638 million), and leisure and hospitality (1.405 million). The highest openings rates were in leisure and hospitality (8.2 percent), professional and business services (7.7 percent), and education and health care (7.1 percent).

The number of private-sector quits ticked higher in August, coming in at 3.937 million, up from 3.850 million in July. Leisure and hospitality led with 956,000 quits followed by trade, transportation, and utilities with 867,000 quits, and by professional and business services with 682,000.

The private-sector quits rate held at 3.0 percent in August. The private-sector quits rates for the last two months are the lowest since May 2021 and 0.4 percentage points below the record high of 3.4 percent in November 2021.

Private-sector layoffs and discharges increased in the latest month, rising to 1.375 million, up from 1.317 million in July. The trend in layoffs

and discharges may be higher since hitting a low of 1.183 million in December 2021. The private-sector layoffs and discharge rate also rose in August, coming in at 1.1 percent, the highest since September 2021.

The number of job seekers (unemployed plus those not in the labor force but who want a job) per opening ticked up slightly in August, rising to 1.137 in August from 0.954 in July (a record low). Before the lockdown recession, the low was 1.409 in October 2019.

The job openings data provide additional evidence suggesting the economy is weakening. While the low number of available workers per opening implies the labor market remains tight, the deterioration at the margin is a warning sign.

Real Core Retail Sales Fell in August, Trend Growth Is Weak

Total nominal retail sales and food-services spending rose 0.3 percent in August following a 0.4 percent decrease in July. From a year ago, retail sales are up 9.2 percent and remain well above the pre-pandemic trend.

Nominal retail sales excluding motor vehicle and parts dealers and gasoline stations – or core retail sales – rose 0.3 percent in August, matching the 0.3 percent gain in July. From August 2021 to August 2022, core retail sales are up 7.6 percent. As with total retail sales, core retail sales remain well above the pre-pandemic trend.

However, these data are not adjusted for price changes. In real terms (adjusted using the CPI), real total retail sales were up 0.2 percent in August following a 0.4 percent decrease in July, a 0.3 percent drop in June, and a 0.6 percent decline in May. From a year ago, real total retail sales are up 0.8 percent versus a ten-year annualized growth rate of 2.5 percent from 2010 through 2019. As with nominal retail sales, real retail sales remain well

above their pre-pandemic trend, but since March 2021, they have been trending essentially flat.

Real core retail sales posted a 0.3 percent decline in August after declining less than 0.1 percent in July. Over the last twelve months, real core retail sales are up 1.2 percent versus a ten-year annualized growth rate of 2.2 percent from 2010 through 2019. While real total retail sales have been trending flat recently, real core retail sales have been trending higher at a rate of 1.2 percent per year.

Categories were generally higher in nominal terms for the month, with eight up and five down in August. The gains were led by motor vehicles and parts retailers, up 2.8 percent for the month, followed by miscellaneous retailers (1.6 percent), building materials, gardening equipment and supplies (1.1 percent), and food services and drinking places (1.1 percent).

Gasoline spending led the decliners with a 4.2 percent drop. However, the average price for a gallon of gasoline was \$4.21, down 11.8 percent from \$4.77 in July, suggesting price changes more than accounted for the drop. Other declines came in furniture and home furnishings (-1.3 percent), nonstore retailers (-0.7 percent), and health and personal care stores (-0.6 percent).

Overall, nominal total and core retail sales remain well above trend. However, rising prices are still providing a significant boost to the numbers. In real terms, total retail sales rose slightly following three consecutive declines and have been trending flat since March 2021. Real core retail sales posted a second consecutive monthly decline but appear to have a modest upward trend, though the growth rate is well below its pre-pandemic pace.

Unit Auto Sales Improved in September but Remained Weak

Sales of light vehicles totaled 13.5 million at an annual rate in September, up from a 13.1 million

pace in August. The September result was a 2.9 percent increase from the prior month and the third decrease in the last four months. It was the sixteenth consecutive month below the 16 to 18 million range, averaging just 13.53 million over that period. Weak auto sales are largely a result of component shortages that have limited production, resulting in plunging inventory and surging prices.

Breaking down sales by the origin of assembly, sales of domestic vehicles increased to 10.64 million units versus 10.34 million in August, a rise of 2.9 percent, while imports rose to a 2.85 million rate from 2.78 in August, a rise of 2.6 percent. Domestic sales had generally been in the 13 million to 14 million range in the period before the pandemic, averaging 13.3 million for the six years through December 2019. The domestic share came in at 78.9 percent in September versus 78.8 in August.

Within the domestic light-vehicles category, domestic car sales were 2.09 million in September versus 1.99 million in August, a gain of 5.0 percent. Domestic light truck sales were 8.55 million versus 8.35 million in the prior month, an increase of 2.4 percent. That puts the domestic light truck share of total domestic auto sales at 80.4 percent.

Domestic assemblies increased in August, coming in at 10.48 million at a seasonally adjusted annual rate. That is up 0.9 percent from 10.38 million in July but still below the 10.8 million average pace for the three years through December 2019.

Component shortages, especially computer chips, continue to restrain production for most manufacturers, creating scarcity for many models and leading to lower inventory and higher prices. Ward's estimate of unit auto inventory came in at 120,300 in August, up from 96,900 in July, its highest level since August 2021. The Bureau of Economic Analysis estimates that the inventory-to-sales ratio rose to 0.665 in August, up from 0.511 in July and the highest level since August 2021.

The average consumer expenditure for a car fell to \$32,379 in August, down 2.8 percent from July. However, the average consumer expenditure on a light truck rose to \$49,985 from \$49,488 in July, up 1.0 percent for the month and a new record high.

As a share of disposable personal income per capita, average consumer expenditures on a car fell to 57.80 percent versus 59.63 in July while the average consumer expenditure on a light truck as a share of disposable personal income per capita was 89.23 percent versus 88.63 percent in July.

CAPITAL MARKET PERFORMANCE

(Percent change)

	September	Latest 3M	Latest 12M	2021	Calendar Year 2020	2019	3-year	Annualized 5-year	10-year
Equity Markets									
S&P 1500	-9.4	-5.2	-16.8	26.7	15.8	28.3	6.2	7.0	9.5
S&P 500 - total return	-9.2	-4.9	-15.5	28.7	18.4	31.5	8.2	9.2	11.7
S&P 500 - price only	-9.3	-5.3	-16.8	26.9	16.3	28.9	6.4	7.3	9.6
S&P 400	-9.4	-2.9	-16.6	23.2	11.8	24.1	4.4	4.2	8.3
Russell 2000	-9.7	-2.5	-24.5	13.7	18.4	23.7	3.0	2.2	7.1
Dow Jones Global Large-Cap Index	-9.7	-7.6	-22.0	16.2	14.7	23.8	2.0	2.7	5.2
Dow Jones Global Large-Cap ex-U.S. Index	-10.1	-10.3	-26.5	4.9	8.8	18.2	-3.6	-2.9	0.6
STOXX Europe 600 Index	-6.6	-4.8	-14.7	22.2	-4.0	23.2	-0.5	0.0	3.7
Bond Markets									
iShares 20-plus Year Treasury Bond ETF	-8.4	-10.8	-29.0	-6.0	16.4	11.5	-10.5	-3.9	-1.9
iShares AAA - A Corporate Bond Fund	-5.2	-6.0	-19.5	-4.2	7.1	9.1	-6.1	-3.0	NA
Commodity Markets									
Gold	-2.7	-7.4	-4.9	-4.0	24.8	18.7	4.3	5.5	-0.6
Silver	6.0	-6.8	-11.6	-12.8	46.8	16.7	3.3	2.4	-5.8
Refinitiv CoreCommodities CRB total return index	-7.4	-7.2	18.4	38.5	-9.3	11.8	16.3	9.2	-0.7

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

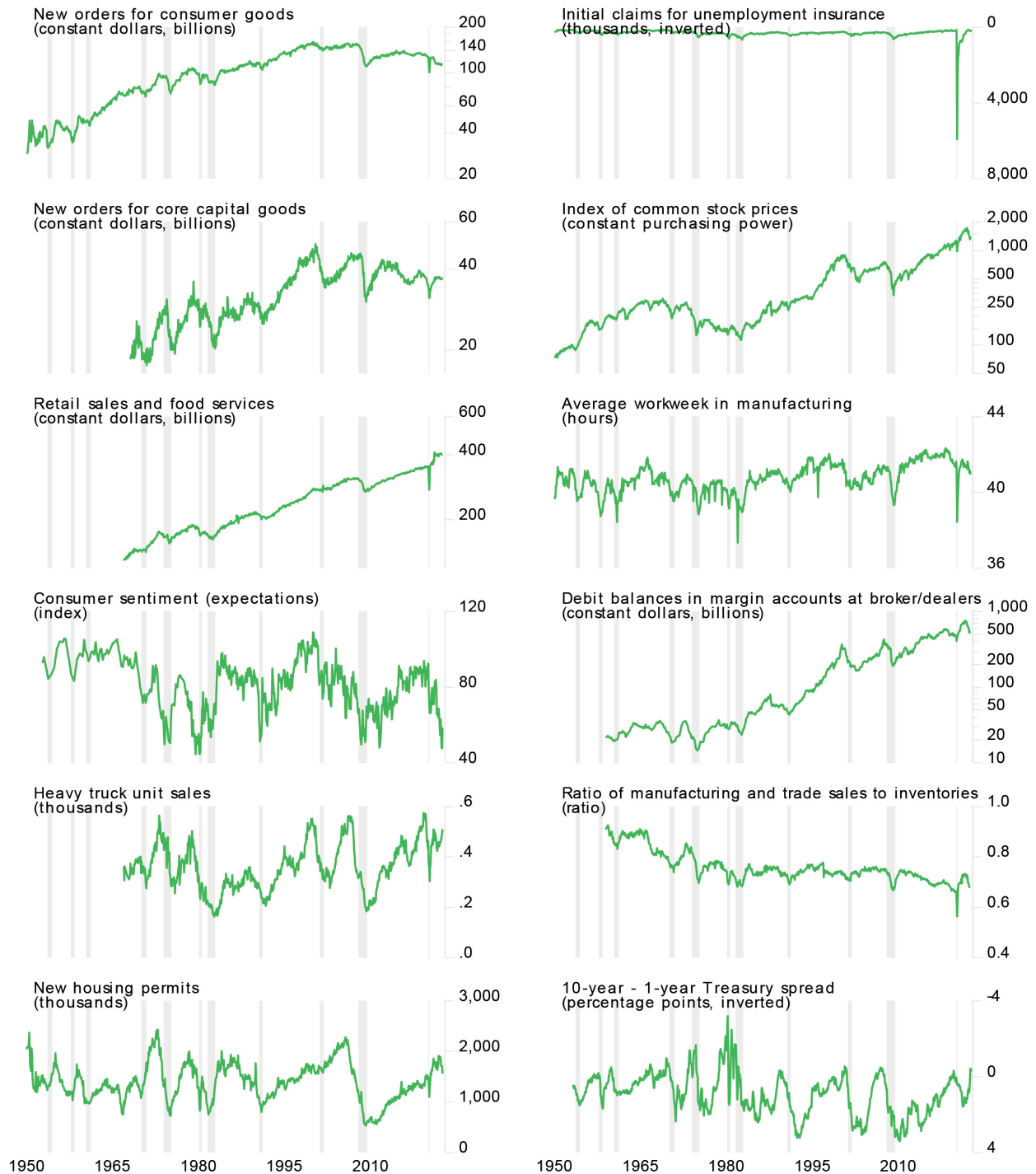
CONSUMER FINANCE RATES

(Percent)

	September	Latest 3M	Latest 12M	2021	Average for Year 2020	2019	Average over Period 3-year	5-year	10-year
30-yr. fixed mortgage	5.2	5.4	4.2	3.0	3.1	3.9	3.5	3.8	3.9
15-yr. fixed mortgage	4.6	4.6	3.4	2.3	2.6	3.4	2.9	3.2	3.2
5-yr. adjustable mortgage	4.4	4.3	3.3	2.6	3.1	3.6	3.1	3.3	3.1
48-month new car loan	5.2	5.2	4.9	5.1	5.1	5.4	5.1	5.1	4.7

Sources: Bankrate, Federal Reserve.

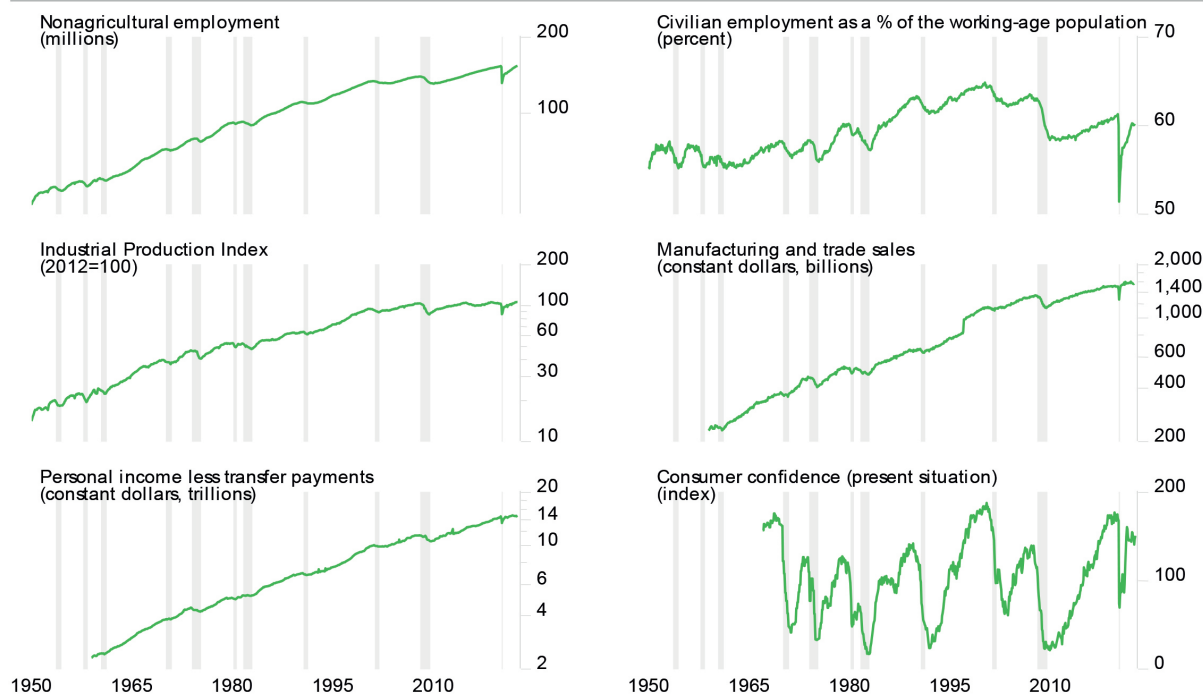
LEADING INDICATORS (1950 - 2022)



Note: Shaded areas denote recessions.

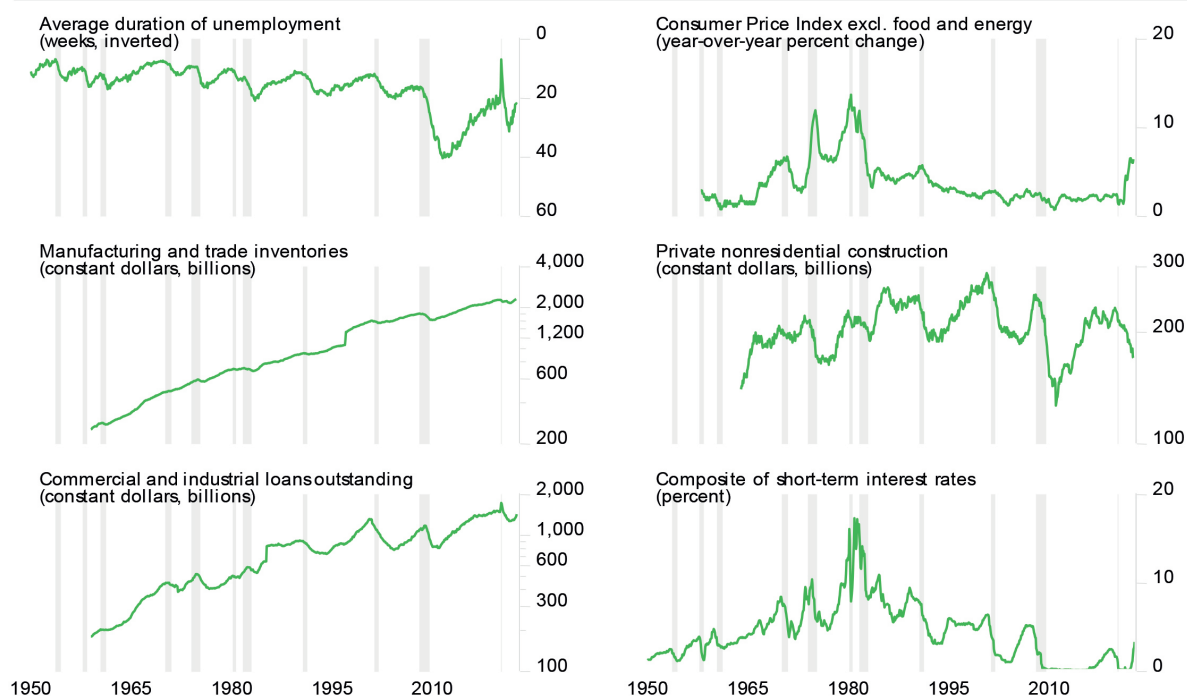
Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, The conference Board, Census Bureau, Department of Labor, Federal Reserve, Institute for Supply Management, Standard & Poor's, AIER (Refinitiv).

ROUGHLY COINCIDENT INDICATORS (1950 - 2022)



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 (1950 - 2022)



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).

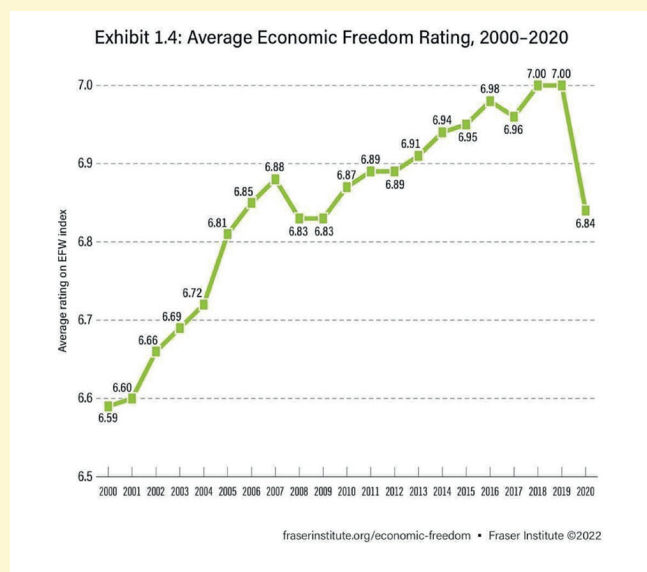
U.S. Economic Freedom Index Collapses to Carter Administration Levels

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The Fraser Institute's *Economic Freedom of the World 2022* report was released this morning. This report covers 2020, which while most of our recent history is a bit of a blur, was the year when COVID-19 and COVID lockdowns defined our shared experience. The first of those lockdowns began in mid-March, and we spent most of the rest of 2020 figuring out how to negotiate a newly defined world. So whatever we end up seeing in the report, we'll have to remember that we spent about 80 percent of 2020, for lack of a better word, grounded.

When additional years of data from the COVID era are added, we fully expect that economic freedom around the world will continue to falter. But let's not get ahead of ourselves. The 2020 data is bad enough. The global average economic freedom rating fell .14 points in 2020, erasing a decade's worth of improvements.



But first, some notes on what the Fraser Institute measures.

The *Economic Freedom of the World* report comprises measurements across five categories and 165 jurisdictions: size of government, legal system and property rights, sound money, freedom to trade internationally, and regulation. Perhaps the most important facet of the report is that we can look at the data in absolute terms, asking, for example, how well the United States has been doing over time. We can also look at the data in relative terms, asking how well the United States has been doing compared to the other nations of the world.

We have become accustomed to seeing a steady climb to better lives. Indeed, many of us could not comprehend living as our grandparents did. But thanks to the Fraser Institute, we now have detailed data from 1980–2020, detailing two generations. How do we stack up?

Many will be surprised that the United States is not at the top of the list of most-free countries. In 2020 the US was seventh, behind Hong Kong, Singapore, Switzerland, New Zealand, Denmark, and Australia. And while seventh in the world is nothing to sneeze at, the US trajectory has been downward for quite some time, if only moderately so. In 1980 and 1990, the US was the second economically freest nation in the world. In 2000, it was third. In 2010 and 2015 it was fifth and sixth, respectively. And by 2020, it was seventh.

But that only tells part of the story. It's when we look at ratings rather than rankings that things get interesting. While the United States has been kicking around in the top ten, even if falling, for decades, it is not doing all that well when compared to itself over time. Indeed, the US's cumulative rating of 7.97 is considerably lower than its 1980

rating of 8.34. Digging into the recent data, the United States dropped in rank across all five indexed categories from 2019 to 2020. The most significant changes have been in the size of government and regulation categories, where the United States fell 7.32 to 6.79, and 8.68 to 8.11, respectively. Both measures directly reflect the COVID era's unprecedented expansions of government, as federal spending was unleashed from any semblance of fiscal constraint and draconian regulatory intrusions on daily economic life reached every single American.

In short, the United States finished 2020 less economically free than we were at the tail end of the Carter years.

In the time since COVID, these problems have only continued to compound. The United States appears to be entering the same economic malaise of bloated bureaucracy, excessive taxation, and spiraling inflation that typified the Carter years. Back then we had to wait in line, sometimes for hours, just to buy gas. Now we have rolling blackouts and energy crises in some states, impending electric vehicle mandates, perpetual budget-busting deficits that were unheard of even two decades ago, and – yes – a return of inflation that tops 8 percent for the year. Perhaps the most telling fact of all is that our elected officials and policymakers haven't a clue how to reverse these trends. Indeed, they are still feeding them.

So where is all this going? Well, 2021 is a full year of COVID lockdowns, so you can bet that data will be worse. We will know then, though, if 2022 shows a reversal of the decline – assuming that the present trends do not continue to compound the problems that COVID lockdowns started.

The real question now is whether we have learned any lessons about economic freedom and lockdowns. These new data provide us an unwelcome warning of what happens when the power of government

becomes unmoored from any restraint, but the trend may yet be reversible.

– September 8, 2022

Wait for It... “It’s Capitalism’s Fault!”

MAX BORDERS

Contributor

An economic crisis looms. When the brown matter hits the proverbial fan, the blue-check commentariat will blame “capitalism.” So we have to remain vigilant.

In fact, they’ve already started.



Richard D. Wolff @profwolff · Jul 17

Inflation whacks the working class: over last year, wages rose LESS than prices. Thus the real wage (what your wage affords) FELL almost 3 %. In the first half of 2022 real wages fell even faster. **Capitalism**: a burden the working class does not need.

I use scare quotes because so few clearly define what “capitalism” is, and fewer still know how it works. Particularly when they use the F word.



Max Berger @maxberger · Aug 28

The struggle for America in the 21st century is whether democracy will move us towards socialism, or **capitalism** will move us towards fascism.

As with *neoliberalism*, “capitalism” is more or less a smear used by those who hate that which they neither understand nor have a hand in creating. Ignorance as a rhetorical strategy works mainly because the masses have become more credulous and ignorant with each passing year. Critics simply have to indicate some socio-economic phenomenon they don’t like and blame the c-word.

Intervention, the C Word, and the F Word

When I use *capitalism* I have a specific set of features in my mind, as we’ll see. Because capitalism is Marx’s term, we could use other less loaded words, such as entrepreneurial markets. But these can come across as esoteric or imprecise. Detractors frequently have something else in their minds, and there is no incentive to determine any common reference frame. Sometimes their very identity is caught up

in being anti-capitalist. It’s one thing to challenge their positions. It’s quite another to challenge their identity.

What’s worse, the politically powerful actively destroy the ideal features of an entrepreneurial market system, often to compromise with anti-capitalists. They then blame capitalism for every failure of intervention. This process began long ago. Now, the best we can say is *interventionism* creates ideal conditions under which corporations and authorities may collude. And boy they do. The extent to which entrepreneurs ally with government officials is the extent to which the system becomes less capitalist, less liberal, and more corrupted by degree.

But what beast does this corruption spawn?

Intervention gives rise to either cronyism or fascism. The difference between cronyism and fascism lies *only* in the authorities’ objectives. Cronyism is designed to shore up the incumbency of individual politicians. Fascism is more about directing the interests of corporations to authority’s ends on behalf of the so-called national interest, and cronies benefit anyway.

Author David Boaz points out this inconvenient truth when he writes:

On May 7, 1933, just two months after the inauguration of Franklin Delano Roosevelt, the *New York Times* reporter Anne O’Hare McCormick wrote that the atmosphere in Washington was “strangely reminiscent of Rome in the first weeks after the march of the Blackshirts, of Moscow at the beginning of the Five-Year Plan.... America today literally asks for orders.” The Roosevelt administration, she added, “envisages a federation of industry,

labor and government after the fashion of the corporative State as it exists in Italy.”

Don’t today’s progressives envisage a federation of industry, labor, and government?

Ain’t it funny that those who are so quick to call others fascist are in full-throated support of authorities directing corporations to do the state’s bidding? Like Keynes, they justify this vaguely in terms of the “national interest” not the rights of the individual. And Mussolini agrees:

Anti-individualistic, the Fascist conception of life stresses the importance of the State and accepts the individual only in so far as his interests coincide with those of the State, which stands for the conscience and the universal, will of man as a historic entity. It is opposed to classical liberalism which arose as a reaction to absolutism and exhausted its historical function when the State became the expression of the conscience and will of the people. Liberalism denied the State in the name of the individual; Fascism reasserts the rights of the State as expressing the real essence of the individual. And if liberty is to be the attribute of living men and not of abstract dummies invented by individualistic liberalism, then Fascism stands for liberty, and for the only liberty worth having, the liberty of the State and of the individual within the State.

Whether that means threatening social media companies to silence dissent, mandating experimental vaccine products, or rewarding banks for their risky behavior, the real fascists get off scot-free.

If that weren’t enough:

Fascism entirely agrees with Mr. Maynard Keynes, despite the latter’s prominent position

as a Liberal. In fact, Mr. Keynes’ excellent little book, *The End of Laissez-Faire* (1926) might, so far as it goes, serve as a useful introduction to fascist economics. There is scarcely anything to object to in it and there is much to applaud.

Thus, we can no longer allow people to blame capitalism for fascism, particularly when unwitting fascists advocate for these policies. So when it comes to playing the blame game for the next major crisis, we have to call a spade a spade—courageously, consistently, and unrelentingly.

A More Perfect Capitalism

But first, we need to identify some of the main features of capitalism.

1. Requires private ownership of the means of production, including extensive property rights in land, capital, and profits.
2. Involves patterns of production and trade in which any collaborative venture (however organized) earns revenues in excess of costs due solely to customers’ willingness to pay.
3. Includes legal agreements that allow founders, workers, and investors to cooperate in service of a mission. (Such agreements can include worker cooperatives.)
4. Operates according to agreements between or among parties to exchanges.
5. Includes arbitration systems based on the Common Law, in which parties settle disputes where injured parties can be made whole.

Capitalism also means a highly competitive system defined by the *absence* of state intervention.

6. To the extent they exist at all, governments should function as referees neither subsidizing

nor taxing organizations.

7. To the extent they exist at all, governments leave individuals to pursue their associations freely, so long as those associations are peaceful.
8. To the extent that government or private courts making rulings, their rulings should be restricted to adjudicating frictions between parties, identifying sources of injury or contract violation, and determining/enforcing fair recompense.
9. To the extent state regulations exist, these become the product of impartial courts who make decisions based on evidence and case law, not statutes nor fiat regulations.
10. To the extent state-sanctioned central banks exist, their role should be limited to ensuring sound and relatively stable money.

Some will argue that the above list is too Utopian—that is, it’s not politically feasible to discard the topheavy layers of our intrusive bureaucracies and their corporate supplicants. That might be true but that also means the system we have ain’t capitalist.

That’s Not Capitalism

Remember, interventionists will blame capitalism for the problems of interventionism, especially if the intervention involves corporations.

- When legislators shut down businesses for months based on COVID histrionics and then pass five pork-laden “emergency” spending bills with money the government doesn’t have, none of that has to do with capitalism.
- When Marxist professors blame capitalism for inflation, we have to remind them that *money printing* causes inflation, which is not a feature of capitalism *per se*. Instead, central banking is the government’s legal counterfeiting scheme that benefits the powerful.

- When Central Banks engage in quantitative easing, interest rate manipulations, capital controls, or yield curve inversions, that’s not capitalism. It’s been progressive technocracy since 1913.
- When a President first tightens the screws on domestic energy production – all while blaming our enemies for “price hikes” compounded by the economic sanctions he ordered – that’s not capitalism. (Note Putin’s invasion of Ukraine is not capitalism either.)
- When a President fails to reform a government sanctioned and subsidized student loan scheme, but forgives the debts of those adults who freely chose to avail themselves of that scheme (sending the rest of us the bill), that’s not capitalism.

The problems we must now face flow from politicians and central bankers trying to stick their (visible) hands into our economic ecosystems, which they refer to as interventionism—i.e. managing the *mixed* economy. (Keynesianism will also do.)

“These two systems, capitalism and collectivism,” writes economist Sandy Ikeda, “organized according to two diametrically opposite principles — spontaneous order and deliberate design — mix as well as oil and water.”

No wonder it’s hard for people to disentangle market failure from government failure.

“Trying to blend them,” adds Ikeda, “produces chaos because it’s impossible to combine two contradictory organizing principles into a coherent system.”

You can see how easy it is to blame the failures of the mixed economy on capitalism. Indeed, to the extent “neoliberalism” is the incoherent doctrine of the mixed economy, we might one day find common cause with those who bandy that term about unreflectively.

But I doubt it.

Most of what passes for commentary about economics today amounts to bleating from herds who think that the cure for every social ill is to tax more resources from the billionaires or the corporations. But as our friend, economist Antony Davies, reminds us,

The 550 U.S. billionaires together are worth \$2.5 trillion. If we confiscated 100% of their wealth, we'd raise enough to run the federal government for less than eight months. (Updated figures might get you to nine months, says Politifact.)

Of course, if the state succeeded in such confiscation, it would be catastrophic.

Government Debt and Intervention

The problem isn't capitalism. The problem isn't greed *per se*—or maybe it is. Too many people want to live at others' expense or charge the national credit card, which – at 138 percent of GDP plus unfunded liabilities – is maxed out.

So when it comes to laying blame, we have to start getting more specific. Yes, there are bad individual actors, bad corporate actors, and bad government actors. But instead of blaming entrepreneurial capitalism, which is just a *system for people sustainably to serve each other*, it's time to blame those who keep intervening to "save capitalism" or those who keep trying to save us *from* capitalism. And it's time to blame those whose failures of imagination always end up in one of interventionism's ideological ditches: *regulation or redistribution*.

The trouble with interventionism is that you can't have it in any form without bundling in some measure of fascism. That's because these two ideologies are kissing cousins. Unless the people regulate the government and redistribute its power

back to individuals, we will lurch from crisis to crisis that interventions cause. And our fascist/socialist enemies will just double down.

– September 3, 2022

Wanted: Economic Literacy

PER BYLUND

Contributor

Economist Thomas Sowell once wrote, “The first lesson of economics is scarcity: there is never enough of anything to fully satisfy all those who want it. The first lesson of politics is to disregard the first lesson of economics.”

The truth of Sowell’s words has probably never been more obvious than today. Contemporary politics disregards scarcity, if not economics itself, and blatantly so. Politicians, bureaucrats, and pundits no longer pretend to recognize basic economic facts but appear even to take pride in proposing policies that fly in the face of sound economics.

But politicians should perhaps not be blamed for disregarding economics and, specifically, scarcity. They have every incentive to do so. The more they manage to promise without having to consider the “unseen” (the cost and what else is lost), the greater their chances of being elected and gaining influence. So they should be expected to act this way. The problem is the reason politicians can get away with it. The population at large does not recognize the impossibility of the promises.

Economic illiteracy is the core problem

While there is reason to despise politicians for opportunistically engaging in a bidding war with other people’s money, the problem arises due to widespread economic illiteracy among people in general. Politicians meet little-to-no resistance and are rarely questioned as they suggest economically disastrous policies (the ever larger stimulus packages, welfare state expansions, endless wars, pork to win elections) because we, as a population, do not know better.

In this sense, we only get the politicians we deserve. Or, to put it slightly differently, we get the policies we do not have the wisdom to reject. When voting and expressing support for politicians and policies, our ignorance will not allow us to escape the consequences of unsustainable and destructive policies. Everything has a cost. Whether we understand this or not, the cost is real. This chicken *will* come home to roost.

How could it be that we have an educational system that takes practically everyone through twelve, if not sixteen, years of schooling, but leaves almost everyone economically illiterate? Part of the answer is likely that economics education is all but terrible and does not focus on providing students with any understanding of how the market economy works. There are other potential answers as well, but this is an important one.

Economics education has the wrong focus, the subject is taught by the wrong people and in the wrong way, and fails miserably to make the study of the economy exciting. Instead, economists manage to turn people away from the subject. Many people even reject economics as “ideology,” not rarely, but ironically, on a purely ideological basis.

The queen of the social sciences

Often referred to as the queen of the social sciences, economics is by far the hardest, the most non-ideological, of the social sciences. It may be the scholarly field of study that is least open for ideology. Economics, when done properly, is as hard a science as there can be. It is a harder science than physics.

Economic theory is traditionally a deductive undertaking, which means it is derived logically

from some reasonable or true starting point. For this reason, it simply has very little room for ideological influence. A theory can be wrong or ideologically charged in two ways: either the starting point is normative or ideologically slanted, or the logic is flawed in some ideological direction.

In the Austrian School, which is the most consistently deductive of traditions in economic theorizing, the starting point for logical deduction of economic theory is the action axiom, that action is *purposeful behavior*. Actions, in other words, are always directed at attaining some personally valued end the actor expects to improve his situation.

While there are plenty of critics of Austrian economics, many of whom claim it is ideological, the critique is based on a fundamental misunderstanding. Austrian economic theory is purely deductive, so whatever ideology there might be must be found either in the definition of action or in the logical derivations from it. No critic has managed to point out wherein human action as purposeful behavior is an ideological claim, nor what logical derivations are unfounded or normative.

Inviting the critics, excluding the students

Unfortunately, mainstream economics is not nearly as consistently deductive as the Austrian school, which means its theory development is more generous and, therefore, at greater risk of being affected by normative judgments. This does not mean economics is more ideological, only that it is at greater risk of its being so unless the scholars are very careful in their scholarship. From an Austrian perspective, mainstream economics opens the field of study to unnecessary criticism and suspicion.

Instead of going back to the field's roots and its proper basis in deductive theorizing, mainstream economics has over the past century taken steps in the opposite direction by adopting formalized modeling and empirical analysis. This means the

theory is not as reliable as it used to be, but also that it is expressed in ways that only experts in the field can decipher.

Economics today looks much like physics, giving the field an air of hardness that economists benefit from in various ways. They can, for example, leverage their technical skill and access to enormous data sets to produce very precise predictions which can be used to argue for or against specific policies. This has allowed economists to enter the halls of power and become an integral part of policymaking, even though their predictions typically turn out wrong.

Make economics great again

The problem with the highly technical economics of the contemporary mainstream is that the economic reasoning that was once core to the field, and that produced the stable foundation upon which modern economics was built, is increasingly forgotten. Not only is modern economics fraught with errors and misconceptions, but it is rather useless for regular people.

Studying economics used to be an eye-opening enterprise. The economic way of thinking, in stark contrast to the study of formal models and advanced statistical analysis, provides a fundamental understanding of the world around us. Economic reasoning is enlightening because it allows us to see and understand the mechanisms and processes that generate the phenomena we can observe.

The rationale for my new book, *How to Think about the Economy: A Primer* (Mises Institute, 2022), is to provide the reader an opportunity to gain economic literacy in the sense that economics used to – that is the legacy of economics. As I state at the very beginning of the first chapter:

Economics is an exciting field.

The economics of old sought to uncover how the world works. It showed, or even proved, that there is a natural order to it. There is

structure to the apparent chaos. The economy has something of a life of its own: it has a nature. This means not only that we can study it and learn about its ways, but also that we are not free to tamper with it at will and cannot make it work in ways that we might prefer but that are not in line with its nature. There are “laws” by which the economy works, and they are immutable. Economics over the past three centuries has been about identifying, learning, and understanding those laws.

By providing this fundamental understanding, economics really shines and can have a positive impact on society. It starts with understanding the concept and implications of scarcity, as Thomas Sowell’s “first lesson” teaches, and unfolds from there.

Economics is in a very real sense a *way of thinking* that is continuously enlightening to whomever masters that science. It is not about memorizing lemmas or models, or of learning technically sophisticated methods. It’s something much more fundamental: an understanding of how the world works.

– September 14, 2022

The Inflation Tide Appears To Be Turning

WILLIAM J. LUTHER

Director, Sound Money Project

The Federal Reserve's decision to tighten monetary policy may finally be paying off. The Personal Consumption Expenditures Price Index (PCEPI), which is the Fed's preferred measure of inflation, grew at a continuously compounding annual rate of 6.0 percent from July 2021 to July 2022, down from 6.5 percent in the previous month.

Lower inflation is welcome news. Prices have grown at a continuously compounding average annual rate of 4.1 percent since January 2020. As a result, the price level was 5.8 percentage points higher in July than it would have been if the Fed had hit its 2 percent inflation target since January 2020. In May 2022, Pew Research reported that Americans saw inflation as the country's top problem—and by a wide margin.

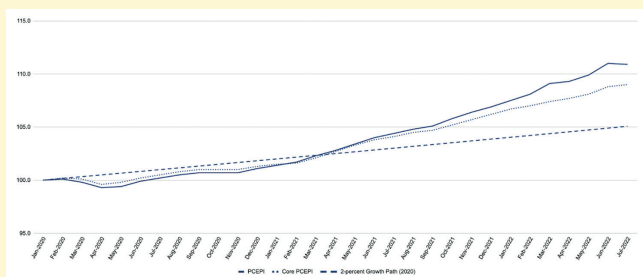


Figure 1. Personal Consumption Expenditures Price Index, January 2020 – July 2022

Some will no doubt overstate the progress Fed officials have made in recent months by putting too much weight on the monthly headline inflation rate. The PCEPI declined 0.1 percent in July 2022. However, this has much more to do with volatile energy prices than monetary policy. Energy prices, which grew 43.4 percent from June 2021 to June 2022, declined nearly

4.8 percent in the month of July 2022.

Others will understate the Fed's progress by putting too much weight on annual rates. Although 6.0 percent is less than 6.5 percent, it is still much higher than the Fed's stated goal of 2 percent inflation on average. Core PCEPI, which excludes volatile food and energy prices, has also grown faster than 2 percent over the last year. From July 2021 to July 2022, core PCEPI grew at a continuously compounding annual rate of 4.5 percent. From these annual rates, some will erroneously conclude that inflation remains high and Fed policy has not yet had much of an effect. Those conclusions might be true, but they do not follow from one's observation of the annual rates.

To see why one should not rely on annual rates to assess the effects of the Fed's change in policy, start by recognizing that its change in policy occurred very recently. The Fed raised its federal funds rate target by 50 basis points in May 2022. It then surprised markets with a 75 basis points hike in June, and followed up with another 75 basis points hike in July. One might date the change in Fed policy to May or June 2022. I would argue that the latter is more appropriate.

Next, recall that annual inflation rates reveal how much prices have grown over the prior twelve months. If one dates the change in policy to the June 2022 Federal Open Market Committee meeting, then ten and a half months covered by the most recent annual inflation rate occurred before the Fed's change in policy. We know that prices grew rapidly prior to the Fed's

change in policy. That's why the Fed changed its policy! Therefore, a high annual rate from July 2021 to July 2022 does not necessarily imply that the Fed's recent policy change was ineffective; it might merely reflect that prices rose a lot prior to the change in policy.

In order to consider the effects of the change in policy, we must see how the price level has changed since the new policy went into effect. We should also look past volatile food and energy prices. At present, that means focusing on the monthly core PCEPI inflation rate.

In July 2022, core PCEPI grew 0.1 percent. That amounts to a 1.1 percent continuously compounding annual core inflation rate. In the previous month, core PCEPI grew 0.6 percent, or nearly 7.8 percent on a continuously compounding annualized basis. That's a huge reduction in the monthly core inflation rate, which suggests that monetary policy has started to bring down inflation.

Core PCEPI is currently 3.8 percentage points higher than it would have been had prices grown 2 percent per year since January 2020. If the Fed were to deliver a monthly core inflation rate of 0.1 percent every month for the next year, it would reduce the gap between core PCEPI and the 2 percent growth path by more than 20 percent. Prices would still be elevated relative to what was expected prior to the pandemic, but much less so than they are now.

Alas, there is little reason to expect the Fed will continue to deliver a monthly core inflation rate of 0.1 percent. Although its average inflation target would seem to require reducing the gap between core PCEPI and the pre-existing 2 percent growth path, Fed officials do not intend to do that. Instead, they intend to see prices grow 2 percent per year on average *beginning sometime after 2024*. In the

meantime, they project inflation will remain high, though not as high as it has been over the last year, with monthly core inflation around 0.2 percent and the gap between core PCEPI and the 2 percent growth path plotted from January 2020 slowly increasing in 2023 and 2024.

Of course, it is also possible that the Fed has not yet gotten a handle on inflation. It is hard to have much confidence with only one month's worth of data. Perhaps the low core inflation rate observed in July is just a blip. It wouldn't be the first time a one-month core PCEPI inflation reading prompted undue optimism. For example, the monthly core PCEPI inflation rate fell from 0.4 percent in August 2021 to 0.2 percent in September 2021. It then hit 0.5 percent for four consecutive months. Many incorrectly predicted that inflation would fall following the September 2021 reading when, in fact, it was about to surge.

Still, the most recent inflation data provides some scope for optimism. After a long delay, the Fed finally seems to be bringing inflation down. It doesn't plan to bring inflation down quickly, nor to offset the high inflation we've experienced over the last year. But at least it does not intend to let prices continue to grow as fast as they have. If monthly core inflation rates are at or below 0.2 percent in August and September, we might more confidently conclude that the Fed is back on track. Until then, we can only hope for the best.

– September 5, 2022

Five Questions for Fed Chair Jerome Powell

THOMAS L. HOGAN

Senior Research Faculty

First published by The Hill

Federal Reserve Chair Jerome Powell has come under criticism for seriously underestimating and then failing to respond to the recent high levels of U.S. price inflation. The Federal Open Market Committee (FOMC) may have finally shifted gears by raising interest rates 0.75 of a percentage point at its June meeting. But many questions remain about Fed policy and its plans to address inflation.

The FOMC typically meets eight times per year to determine the stance of monetary policy. After each meeting, Chair Powell holds a press conference where he takes questions from the media. Most reporters ask about the state of inflation or the Fed's interest rate decisions, while important policy questions go unasked.

Here are five important questions that would help the public better understand the Fed's monetary policy.

1. What is the Fed's inflation target for 2022?

Prior to the pandemic, the FOMC had a stated goal of 2 percent annual inflation. In August 2020, the FOMC announced a new policy of average inflation targeting (AIT).

Powell explained that this new regime is intended to average 2 percent inflation over time. He gave the example that "when inflation has been running below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time."

That language seemed to imply that the opposite would also be true: that when inflation is running above 2 percent, the Fed would aim to achieve inflation moderately below two percent in the future

in order to average 2 percent over time. However, Powell has since clarified that this is not the case. "There's nothing in our framework about having inflation run below 2 percent," he said. In other words, the AIT is not a symmetric policy.

Under an asymmetric AIT, the Fed promises to compensate for periods when inflation falls below the long-run target. It makes no such promises for periods when inflation rises above the long-run target, as it has over the last 15 months. Compared to a symmetric AIT, the future price level under an asymmetric AIT is much harder to predict.

Given this uncertainty, it seems fair to ask: What are the FOMC's inflation targets for the short and medium terms, and does Powell expect to achieve those targets?

2. How can an asymmetric average inflation target anchor expectation?

When the Fed adopted its AIT, it said the new policy would help "anchor long-term inflation expectation." But the policy – as clarified by Powell – does not seem to be consistent with that goal.

While a symmetric AIT might help anchor inflation expectations, an asymmetric AIT regime risks inflation expectations becoming unanchored. There is no clear expectation for the short to medium term when inflation is above target.

Powell recently acknowledged that "an extended period of high inflation could push longer-term expectations uncomfortably higher." Does he still believe the AIT policy is helpful in anchoring inflation expectations? If so, how does he think it works?

3. Does money cause inflation?

Milton Friedman famously argued that “inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output.”

Chair Powell seems to disagree. In his recent testimony, he said that “there was a time when monetary policy aggregates were important determinants of inflation and that has not been the case for a long time.” He further explained, “the correlation between [...] M2 and inflation is just very, very low.”

It’s not totally clear what Powell meant by this. He mentions both M2 and “monetary policy aggregates.” The relationship between simple sum measures like M2 and inflation are tenuous. However, research by Joshua Hendrickson shows that more appropriate measures of money (i.e., Divisia monetary aggregates) are causally related to nominal spending and the price level.

Powell should be prompted to clarify his view. Does he deny that there is any causal relationship between money growth and inflation? Or does he merely think that money is not the only potential cause of inflation. Perhaps he thinks excessive money growth is not the cause of inflation in this particular case, attributing the rise in prices to supply disturbances instead. Whatever the case, he should be clear.

4. What role does IOR play in monetary policy?

In 2008, when the Fed started quantitative easing (QE) and began paying interest on reserves (IOR) that banks hold at the Fed, it converted its monetary framework from a corridor system to a floor system. Given this change, some economists at the Fed say the rate of IOR, in conjunction with the rate on overnight reverse repurchase agreements (ONRRPs), is the “key tool” of monetary policy.

But Chair Powell seems to disagree. He discusses the rates of IOR and ONRRPs only as an afterthought

or when specifically asked about them. Even then, he refers to them only as a “technical adjustment” to the Fed’s administered interest rates.

Given the extreme divergence between his statements and those made by Fed economists, it seems worth asking what role Powell believes the rate of IOR and ONRRPs play in the Fed’s monetary policy.

5. Will the Fed withdraw from the Network for Greening the Financial System?

The Fed has recently taken on a new role in climate policy. Powell says the Fed’s role is limited to assessing climate-related risk to the financial system and that it should not be setting broader economic policy related to climate change.

Since 2020, however, the Fed has been a member of the Network for Greening the Financial System (NGFS). The stated purpose of this organization is to “mobilize mainstream finance to support the transition toward a sustainable economy.” More specifically, it aims “to mobilize capital for green and low-carbon investments.”

Powell says that the Fed is not interested in allocating credit, but the purpose of the NGFS is to direct credit to green and low-carbon investments. Will Powell commit to withdrawing the Fed’s membership in the NGFS?

These are important questions that Chair Powell should answer. But, first, the questions must be asked.

– September 16, 2022

Federal Reserve Operating Losses and the Federal Budget Deficit

ALEX J. POLLOCK & PAUL H. KUPIEC

Contributors

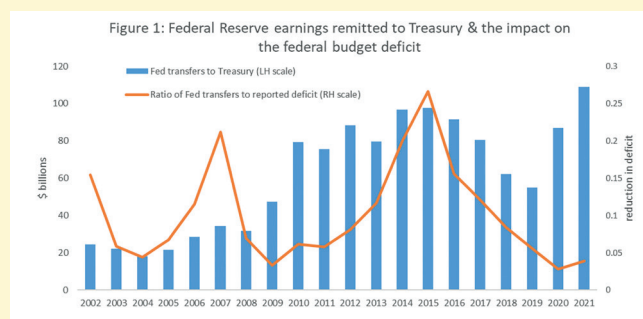
The Federal Reserve remits most of its operating profits to the US Treasury. Federal Reserve remittances are government revenues that directly reduce the federal budget deficit. But what is the budgetary impact of Federal Reserve System losses? The Federal Reserve System has not had an operating loss since 1915, so history provides no guidance as to how these losses will impact the official federal government deficit.

In 2023, the Fed will likely report tens of billions of dollars in operating losses as it raises interest rates to combat raging inflation. Will Fed losses increase the budget deficit as logic dictates they should, or will they be treated as an off-budget expenditure? Given the “transparency” of federal budgetary accounting standards, it is not surprising that a recent Congressional Budget Office (CBO) report suggests Federal Reserve operating losses will be excluded when tallying the official federal budget deficit.

The Federal Reserve earns interest on its portfolio of Treasury and federal government agency securities and receives revenues for the payments system services it provides. Offsetting Fed revenues are the interest the Fed pays on bank reserve balances and reverse repurchase agreements, dividend payments to Fed member banks, contributions (if any) to the Fed surplus account, and the operating expenses of the Board of Governors, the 12 Federal Reserve district banks and their branches. Since 2012, expenses also include the Consumer Financial Protection Bureau. Any remaining earnings are transferred to the US Treasury and counted as federal government receipts for federal budget purposes.

The annual amount of Federal Reserve operating income remitted to the Treasury since 2001 is

plotted in Figure 1. Also shown are estimates of the reductions in the reported federal deficits attributable to the remittances. (The Fed reports remittances on a calendar-year basis, while the federal deficit is calculated for a fiscal year ending September 30. The deficit reduction estimates in Figure 1 do not correct for this timing difference.)



Source: Various US Treasury monthly statements, Federal Reserve Annual Board Reports, and the authors' calculations

In crisis years (2009-2011, 2020-2021) the federal budget deficit is bloated by congressionally appropriated stimulus outlays and reduced tax receipts. In these years, even very large Fed remittances offset only a fraction of the combined federal budget deficit. In years unburdened by massive federal stimulus expenditures, however, Fed remittances offset a substantial portion of the reported deficit.

By the FOMC's own estimates, short-term policy interest rates will approach 3.5 percent by year-end 2022. As the Fed raises short term interest rates to fight inflation, its interest expense increases. The Fed's interest expenses and operating expenditures, including about \$630 million per year in off-budget funding it is required to provide to the Consumer Financial Protection Bureau, will soon exceed its revenues.

Our back-of-the envelope estimates suggest that the Federal Reserve will begin reporting net operating losses once short-term interest rates reach 2.7 percent, assuming the Fed has no realized losses from selling its SOMA securities. If short-term rates reach 4 percent, our estimates suggest that annualized operating losses could exceed \$62 billion. As discussed below, these loss estimates are consistent with the Fed Board of Governors' own public estimates.

In 2011, the Federal Reserve announced its official position regarding realized losses on its investment portfolio and system operating losses:

[I]n the unlikely [sic] scenario in which realized losses were sufficiently large enough to result in an overall net income loss for the Reserve Banks, the Federal Reserve would still meet its financial obligations to cover operating expenses. In that case, remittances to the Treasury would be suspended and a deferred asset would be recorded on the Federal Reserve's balance sheet.

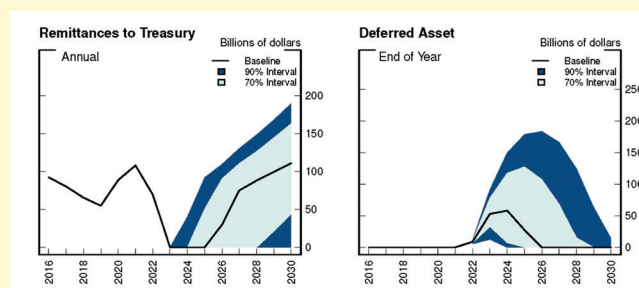
Among financial institutions, the Fed has the unique privilege of setting its own accounting standards, and the Fed has decided that, unlike for all its regulated banks, operating losses will not reduce the Federal Reserve's reported capital and surplus. The Fed will maintain a positive reserve surplus account in the event it books operating losses by offsetting its operational losses, one-for-one, with an imaginary "deferred asset" account, no matter how large the loss. Unless Congress intervenes, the Fed will not remit any revenues to the US Treasury—even as it continues paying dividends to its member banks—as long as this deferred asset account has a positive balance.

Instead of issuing a new marketable Treasury security, which would count towards the deficit,

the Fed will cover its losses with a nonmarketable receivable called deferred assets recorded on the Fed's balance sheet. The economic reality, of course, is that Fed losses increase the government's deficit.

Federal Reserve Board estimates of the system's potential cumulative operating losses are mirrored in estimates of its deferred asset balance pictured in Figure 2. The Federal Reserve Board's own estimates suggest that its cumulative operating losses (in the estimated "90 percent interval" case) could approach \$200 billion by 2026. Moreover, the Fed projects that it may not resume making any Treasury remittances until 2030 or later. Keep in mind that these projections assume the Fed can reduce inflation with fairly modest increases in short-term interest rates with the expected short-term rate path peaking at less than 4 percent in 2023, before slowly declining toward 2.5 percent in 2026.

**Figure 2: Federal Board of Governors
Projection of Treasury Remittances and System
Deferred Asset Account Balances 2023-2030**



Source: FEDs Notes, 2022

While the Board of Governors fully anticipates operating losses beginning in 2023, the CBO did not get that memo. In its most recent forecast, the CBO projects that the Fed will continue making positive remittances to the Treasury every year between 2022 and 2032. While the CBO forecast anticipates a sharp decline in remittances in 2023

through 2025, it expects a recovery toward 2021 remittance levels thereafter, with the Fed reducing interest rates as inflation returns to targeted levels.

While the CBO does not project any Fed operating losses, its explanation of budget accounting suggests any such losses would be excluded from budget deficit calculations: “Although it remits earnings to the Treasury (which are recorded as revenues in the federal budget), the Federal Reserve’s receipts and expenditures are not included directly in the federal budget...” Operating losses will be a Federal Reserve expenditure, so this CBO statement would appear to exclude Fed operating losses from the federal deficit calculation. It is strange not to count the Fed’s losses in the budget accounting, considering that the Fed’s profits are counted. Perhaps because the CBO does not anticipate Federal Reserve losses, it has failed to consider them explicitly in its description of deficit accounting.

Simple accounting logic suggests that if the federal budget deficit is reduced when the Fed earns revenues in excess of expenses and remits these profits to the US Treasury, Fed losses should increase the reported federal budget deficit. This is especially true since Federal Reserve System losses now include the hundreds of millions of dollars of off-budget funding it is required to transfer to run the Consumer Financial Protection Bureau. If the current accounting rules remain unchallenged, the Congress could pass new legislation requiring the Federal Reserve to fund any number of activities off-budget without any impact on the reported federal budget deficit.

– September 7, 2022

There Is No Such Thing As Student Debt Cancellation

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President Biden finally announced his promised student debt relief program. The government will forgive up to \$20,000 of student debt for Pell Grant recipients, and up to \$10,000 for others with an annual income below \$125,000 (\$250,000 if married). On top of this, he is extending the grace period on student loan repayment until the end of the year. The plan is estimated to cost \$24 billion per year for a decade, for a total of \$240 billion.

The victory lap surrounding the announcement suggests the government does not fully understand its own policy. Consider two representative politicians, Kamala Harris and Elizabeth Warren, who describe Biden's policy as debt "*cancellation*." Recent columns in *Forbes* and *CNET* show similar statements. The word "cancel" is very telling; it gives the impression that student debt disappears. The cancellation narrative is reinforced by advocates talking about the benefits of the debt relief, while remaining silent about its costs. There is no such thing as debt cancellation. The loan will be repaid. The only question is who will foot the bill. Recognizing that the Biden administration's policy merely shifts the burden from some Americans to other Americans, the economic and ethical questions involved are more salient than many realize.

The student debt forgiveness policy means the government will forgo roughly \$240 billion in payments over the next decade. How will it deal with this revenue shortfall?? There are a few possibilities. The government may:

- Cut spending
- Raise taxes

- Issue debt
- Create money

The options are not mutually exclusive. The government might employ some combination of the four. But, no matter how you slice it, that \$240 billion dollars will come from somewhere. Basic accounting requires it.

Further, the idea that the government is footing the bill for this policy is a bit misleading. The cost of the program does not fall on the government. It falls on those who miss out on expenditures that would have otherwise occurred, those who pay higher taxes as a result of the program, those who pay higher interest rates or are crowded out due to additional government borrowing, or those who see the purchasing power of their dollars reduced more than usual.

Remember, the government cannot give without taking.

Biden's student debt forgiveness policy raises important ethical questions. For example, individuals making up to \$125,000 a year qualify. But median income in the United States is only around \$45,000. Why should low income Americans pay for loans taken out by those who earn much more?

There are other equity issues, as well. Some students and graduates sacrificed consumption to pay down their loans more quickly and, as a result, will not see as much of their debt forgiven. Those who made the minimum payments or no payments at all will benefit. Those who have repaid their loans in full receive nothing. Why are those who have repaid their loans less deserving of financial assistance than those who haven't?

Further, the possibility that such a policy will be enacted again seems likely to create further problems. Lawrence White predicts individuals will be more inclined to take out larger loans, at higher rates, because there is now a greater chance that Uncle Sam will force someone else to pay for it at some point in the future.

There is no denying that some Americans are struggling, and some of those struggling have student debt. If the Biden administration is genuinely concerned about those struggling, it could provide greater assistance to those with low incomes. If it is genuinely concerned with those struggling to repay their student loans, it could have phased out the debt forgiveness over a much lower income threshold. That it took neither of these paths suggests it is primarily concerned with winning votes from educated elites in the next election at the expense of everyone else.

– September 19, 2022

Loan Forgiveness Myths

ANTONY DAVIES

Contributor

“Forgiveness” is such a kind word that it’s no wonder politicians latched on to it to describe the extremely unkind thing they’re doing to us. Recent discussions on social and mainstream media reveal that the typical voter is not only confused about what “loan forgiveness” means, but (disturbingly) also confused as to what “loan” means.

Myth #1: Student loan forgiveness doesn’t cost taxpayers anything because the loaned money has already been spent.

Yes, the money has already been spent. But that’s not where the cost occurs. Suppose that a student was supposed to pay back \$10,000 five years in the future, and that the government has now just forgiven the loan. Five years from now the government will have \$10,000 less revenue than it otherwise would have. And that means that the rest of us either (1) will receive \$10,000 less in government services than we would have otherwise, or (2) will pay \$10,000 more in taxes than we would have otherwise, or (3) will endure \$10,000 more worth of inflation than we would have otherwise.

The student who has his loan forgiven will end up paying back some of that forgiveness later, likely in the form of higher taxes or inflation. But he’ll only pay back some. Some will be paid by people who already paid for their own student loans. And some will be paid by people who didn’t go to college at all. No matter how you slice it, the government hasn’t forgiven loans. It has instead forced the rest of us to pay them back. Notably, it has forced people who didn’t go to college to pay for those who did.

Myth #2: Forgiving student loans will cause inflation.

Forgiving student loans won’t cause inflation. But, the manner in which the forgiveness is financed could cause inflation. Forgiveness means that the government will be collecting less money in the future from the borrowers. If Congress doesn’t cut spending to match the money it won’t be collecting, and doesn’t raise taxes to compensate for the money it won’t be collecting, then it will have to print money to compensate for the money it won’t be collecting. That will cause inflation. Astute readers may note a fourth option: The government could borrow more in the future to compensate for the money it won’t be collecting. But the government’s borrowing money is the same as raising taxes. It just happens over a different time frame. Rather than raising taxes by a large amount in one year, when the government borrows, it raises taxes in small amounts over many years to pay the interest on the borrowed sum.

Myth #3: Student loan forgiveness benefits private banks.

Contrary to what detractors say, loan forgiveness is not some sort of bank bailout. Way back in 2008, politicians buried in the text of the Affordable Care Act language authorizing the Department of Education to lend directly to students. Consequently, today the Department of Education holds more than 90 percent of student loan debt. Student loan forgiveness applies to this government-held debt, not to debt held by private banks.

Myth #4: Forgiving student loans is good for the economy because those students will be more able to purchase homes and cars.

It is true that student loan forgiveness will give students financial freedom they wouldn't otherwise have – freedom to invest in starting businesses or to buy big ticket items like houses and cars. But this is only half of the truth. For every additional dollar students will be able to spend because their loans are forgiven, the rest of us will have one dollar less to spend because we must pay for the forgiven loans. In the end, there's no positive economic effect. All the forgiveness does is augment students' spending in exchange for diminishing the general population's spending.

Myth #5: Forgiving student loans won't cost that much.

Relatively speaking, the current round of loan forgiveness isn't that big of a deal. In the face of trillion-dollar deficits, another hundred billion or so isn't noticeable. What is worrisome is what comes next. Next year's students will, understandably, want loan forgiveness also. Tuition will rise because now universities don't have to worry about students not attending high-priced schools because the students aren't paying. As tuition rises, there will be a call for even more loan forgiveness. Then there will be an influx of students into colleges and universities who are looking for a four-year all-expenses-paid vacation. This increase in demand for higher education will push tuition up even further. And what will these vacationing students study? On average, they'll want to study easy subjects. And so demand for majors like gender studies and child and family education will skyrocket. When these students hit the job market and can't find jobs in their fields, politicians will hold hearings asking why higher education is costing taxpayers so much and delivering so little. Politicians will then say that,

since the government is paying for higher education, it should have a say in what's going on in higher education. And there we have Public School 2.0. All the problems that the government has brought to public education, it will then bring to higher education.

Myth #6: Student loan forgiveness is good for Americans.

The reality is that student loan forgiveness is good for some students, bad for the rest of us, and the collective pain to the rest of us will exceed the collective good for the students. The one group for whom student loan forgiveness is unquestionably good is politicians. What student loan forgiveness really does is allow politicians to use our money to buy the votes of an entire group of young voters.

In the end, a college degree is either valuable or it isn't. If it's valuable, it will pay for itself. If it's not valuable, no one should pay for it. Either way, there's no reason for the government to be involved in higher education. The more involved it does get, the worse the problem becomes.

– September 6, 2022

Mercantilist Follies, Then and Now

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Reprinted from Law & Liberty

At the 2022 American Economic Forum organized by the Intercollegiate Studies Institute, I had occasion to listen to an after-dinner speech about trade—more precisely, an economic nationalist view of trade—by former US Trade Representative, Robert Lighthizer. Chatting afterwards with students attending the Forum, one of them asked me what I thought of Ambassador Lighthizer’s remarks. My response was: “It was mercantilism, updated for the twenty-first century.” “What’s mercantilism?” she inquired.

What indeed is mercantilism? It’s not a word used commonly today, but mercantilism is shorthand for a set of economic, political, and legal ideas and practices that dominated the European world between 1500 and 1800. “The Mercantile System,” as Adam Smith called it, was also the target of Book IV of his *Wealth of Nations*. It was, as Smith himself later wrote to a Danish correspondent, “a very violent attack . . . upon the whole commercial system of Great Britain.” Smith’s broadside, however, drew back the curtain to show what mercantilism really entailed. The picture that emerged was not a pretty one, but it illustrates why free trade abroad and free markets at home are far preferable to the neo-mercantilist alternatives on offer today.

A Zero-Sum World

One difficulty with analyzing mercantilism is that its proponents rarely laid out a systematic case for it. In his *History of Economic Analysis*, the economist Joseph Schumpeter noted that “mercantilist doctrines” emerged in a scattered fashion from

the early-fifteenth century onwards. This often took the form of pamphlets defending specific economic endeavors or exploring issues like the balance of trade. The most systematic case for mercantilism (and a moderate version at that) was developed by the Scottish Jacobite, Sir James Steuart, in his *Inquiry into the Principles of Political Economy* (1767). Widely read throughout the late-eighteenth century, including by Adam Smith, this text was in many American founders’ libraries.

In other settings, mercantilist ideas were formally laid out in state papers authored by government ministers like Louis XIV’s Controller-General of State Finances, Jean-Baptiste Colbert. This indicates the extent to which mercantilist ideas were driven by the desire to achieve political goals rather than an empirical inquiry into how economies function.

What’s clear from the extant literature is that mercantilism’s economic vision did not emphasize economic growth. Rather, economies were considered largely static. Wealth was thus not believed to come through entrepreneurship, competition, and free exchange. For mercantilists, countries prospered by acquiring as much of the world’s existing wealth as they could.

That basic conviction translated into several things. One was an effort by states to snap up as much territory and dominate as many trade routes as they could handle. Practically speaking, this meant European states like Britain encouraging or organizing colonial settlements around the world and barring British goods from being carried on non-British ships. These policies were backed up by a willingness to use force to protect territorial gains and enforce trade prohibitions.

Part of mercantilism's wealth-acquisition strategy involved governments giving charters to joint-stock companies which conferred upon them a monopoly of a country's trade in particular parts of the world. This produced outfits like the Hudson Bay Company, the Dutch East India Company, and the French East India Company. The most famous of such enterprises, the British East India Company, was created in 1600. By the mid-eighteenth century, it was exercising powers akin to a sovereign state throughout modern-day India and Bangladesh. The East India Company's monopoly of British trade in these regions was gradually accorded subtle and, when necessary, unsubtle protection by British soldiers and the Royal Navy. Such were the close links that mercantilism forged between governments and many merchants.

A second byproduct of mercantilism's static view of wealth was a fixation with balance of trade questions: more specifically, ensuring that you exported more than you imported. Countries went to enormous lengths to try and secure a positive balance of trade. This makes sense if you believe that the sum-total of wealth in the world is finite.

Every time you imported a good from abroad, mercantilist arguments went, you exported wealth in the form of payments of gold and silver. To try and reduce imports, governments sought to create or bolster numerous domestic industries via subsidies and regulation, as well as tariffs on imports to discourage people from buying foreign-made products. In some cases, gold and silver exports were banned. Conversely, exports of goods were encouraged and often subsidized, because this meant that Frenchmen were paying, say, British merchants for British goods, thereby bringing more precious metals into Britain.

False Conceptions of Wealth

This brings us to a central mercantilist proposition: the more gold and silver that a country possessed

and acquired, the wealthier it was. That was part of the economic logic that drove the Spanish conquistadors, with the eventual backing of the Spanish Crown, to conquer Central, South, and much of North America in an astonishingly short period of time.

It turned out, however, that acquiring vast sums of gold and silver did not make nations wealthy. After 1521, Spain experienced decades of enormous precious metal influxes from its American possessions. Yet by the mid-seventeenth century, Spain's economy was stagnating and visibly becoming poorer relative to other European nations. This owed something to Spain being constantly at war with major powers like France, Britain, the Netherlands, and the Ottoman Empire from the mid-1550s until the 1650s. But there is much research illustrating that Spain's economic decline was also partly driven by growing reliance upon gold and silver imports from the New World and the subsequent crowding-out of wealth-producing industries.

Herein lay yet another problem with mercantilism. The Spanish example shows that the essence of wealth is not, as mercantilists held, how much a country possesses by way of precious metals. Adam Smith demonstrated the falsity of that claim as early as his *Lectures on Jurisprudence*. Wealth is our capacity to satisfy our economic needs and wants. Among other things, this means being able to offer others something they want and being prepared to exchange it for something that you want. From this, it follows that the more barriers that you erect to obstruct people's ability to exchange and compete with others (which mercantilism did), the more you inhibit wealth creation.

Indeed, mercantilism discouraged individuals and countries from discovering and then specializing in what they do comparatively better than others. That mattered because the division of labor is key to facilitating the greater efficiencies and productivity that create new wealth. Instead, mercantilism

encouraged governments to create and prop up inefficient domestic sectors, and incentivized merchants to curry favor with governments to extract privileges from them: something unconducive to efficient wealth-creation and positively corrosive to good government.

Law-breaking, Inefficiency, and Cronyism

By the mid-1700s, frustration with mercantilist practices was growing throughout the European world. The high customs duties imposed on imports had resulted in widespread smuggling throughout Europe. This bred disrespect for law but also necessitated vast expenditures on a customs apparatus that tried and largely failed to curb smuggling.

That wasn't the only economic cost related to mercantilism. Mercantilist ideas contributed to the growth of vast European colonial empires. But, as Britain discovered after its comprehensive victory over France in the Seven Years' War, providing the military forces needed to protect and police its huge global possessions and the trade routes between them was a major drain on the public purse. Attempts to make the American colonies pay for what British parliamentarians viewed as their fair share of the costs of maintaining British military establishments in North America helped sparked insurrection and, eventually, a revolution.

Then there were the political and economic dysfunctionalities associated with mercantilist enterprises like the East India Company. As Edmund Burke noted in his *Speech on Fox's India Bill* (1783), the Company's trade monopoly severely distorted the workings of the price mechanism in India and consequently introduced widespread inefficiencies into British trade throughout the region. Worse, Burke pointed out, the Company's monopolistic convergence of economic and political power had corrupted many British colonial officials, merchants, and their Indian counterparts. Young British gentlemen of middling prospects, he famously

stated, went out to India and were quickly turned into "birds of prey."

That corruption had a way of spreading. The East India Company spent vast sums maintaining a strong lobby in Britain's halls of power. It proved exceptionally proficient at nullifying attempts to diminish the Company's monopoly of British trade in the Far East. The fact that, by this point, the British government (and many MPs) was a major shareholder in the Company made the cronyism and corruption positively incestuous and all the harder to break.

Growing dissatisfaction with this state of affairs was not, however, enough to spark reform. Despite some trade-liberalization measures like the 1766 Free Port Acts, which Burke helped pass in Parliament, mercantilism's hold on European economies actually strengthened in the late-eighteenth century. Something else was required to start loosening its grip. That something else turned out to be a book.

Enter Adam Smith

To say that Adam Smith's *Wealth of Nations* intellectually demolished mercantilism is an understatement. For one thing, Smith showed how mercantilist efforts to protect domestic industries didn't increase a country's total output. No regulation, Smith stated, "can increase the quantity of industry in any country beyond what its capital can maintain." Instead, they divert part of a country's capital "into a direction into which it might not otherwise have gone." But, Smith added, "it was by no means certain that this artificial direction is likely to be more advantageous to the society than that into which it would have gone of its own accord."

Smith's point was that tariffs don't bolster production. Output is driven by factors like efficiency, specialization, and the amount of capital invested in an enterprise. Tariffs can only encourage businesses to shift their investments elsewhere, and

there is no possibility of knowing ahead of time if this will boost output.

As for mercantilism's restricting of imports, Smith recognized that this misconceived the purpose of economic production. The goal of production, he stated, was not production itself. Production is a means to an end. And that end is consumption. We don't consume goods and services to promote production. Production is supposed to satisfy consumers' needs and wants. It followed, Smith stated, that "the interest of the producer ought to be attended to only so far as it may be necessary for promoting that of the consumer." The problem, Smith stressed, with mercantilism is that "the interest of the consumer is almost constantly sacrificed to that of the producer; and it seems to consider production, and not consumption, as the ultimate end and object of all industry and commerce."

Furthermore, unlike millions of dispersed consumers, Smith stressed that producers could exert disproportionate influence over trade policy and thus promote their sectional interests at everyone else's expense. In a 1783 letter, Smith contended that "every extraordinary, either encouragement or discouragement that is given to the trade of any country more than to that of another may, I think, be demonstrated to be in every case a complete piece of dupery, by which the interest of the state and the nation is constantly sacrificed to that of some particular class of traders."

Lastly, there was the balance of trade issue. Smith explained how the concept was "absurd." "When two places trade with one another," he wrote, "this doctrine supposes that, if the balance be even, neither of them either loses or gains; but if it leans in any degree to one side, that one of them loses and the other gains in proportion to its declension from the exact equilibrium." Alas, Smith stated, "Both suppositions are false." When two people freely exchange goods within or between countries, Smith saw, they

both "win," albeit to varying degrees, insofar as they both get what they want. Otherwise, neither would have assented to the exchange.

Consumers—Not Producers—Should Rule

With this background in mind, we can see how mercantilist notions shape some of our present economic debates. Balance of trade questions, for instance, still preoccupy many economists who are by no means protectionists. In the case of contemporary economic nationalists, they regularly portray trade between nations in mercantilist terms as a win-lose equation. They focus heavily on trade imbalances, and regard trade deficits vis-à-vis other countries as a "loss." Like the mercantilists of old, they also emphasize building up and protecting specific industries via tariffs, import quotas, and subsidies.

Above all, modern-day economic nationalists follow the mercantilist prioritization of production over consumption. This was one of Lighthizer's central recommendations in his American Economic Forum address. We need, he said, to shift the emphasis of American trade policy away from consumption and "move it towards workers, their families, our communities, production, and values." As these words illustrate, the well-being of American consumers—all 330 million of them—does not rank high on economic nationalism's priority list. Lighthizer even described contemporary free traders' focus on consumers and consumption as "the essence of materialism."

What economic nationalists downplay or ignore is that it is precisely through serving consumers in a competitive market that businesses produce wealth. In these conditions, companies must constantly innovate, find efficiencies, and reduce their margins to outpace their competitors. In the process of doing so, they create new wealth. That same wealth allows businesses to employ millions of people, thereby providing individuals and families

with the salaries, wages, and benefits that enable them to pursue numerous *non-economic* goals. How, I ask, is this materialistic?

But this is not the only reason why “consumer sovereignty,” as the German ordoliberal economist Wilhelm Röpke called it, matters. If the well-being of producers becomes the focus of economic life, it opens the door to the cronyism and often outright corruption that characterized the mercantile system. Certainly, many businesses and their armies of lobbyists insist that they deserve government assistance because they claim to be essential to the well-being of a town, blue-collar men, etc. But as Adam Smith observed of the commercial and political purveyors of mercantilist doctrines of his time, “I have never known much good done by those who affected to trade for the public good.”

The clear analogies between mercantilist practices and present-day economic nationalist impulses remind us that there is little new under the economic sun. As John Maynard Keynes wrote in his *General Theory*, “Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back.” In the case of today’s economist nationalists, their scribblers go back over 250 years. And the prescriptions of those scribes are as mistaken now as they were in their own time.

– September 21, 2022

Modeling the Money Supply

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When economists model the supply of a good or service, they usually describe how its availability on the market responds to its price. This requires making several assumptions about market structure, spillover effects between firms, and property rights enforcement, to name only a few. While the underlying principles of human action are the same, how those principles manifest in the market depends on underlying institutional factors.

How should we model the supply of money? This can be tricky. It's not immediately obvious what the *price of money* means, especially in a fiat-money system. Understanding how different monetary institutions, such as central banks, affect the process adds another layer of complexity. The nature of money, as the economy's most saleable, or liquid, good, makes this harder than for "ordinary" goods and services.

There is no universal model of the money supply. Below, I'll discuss three cases that correspond to historically important monetary institutions: central banking with fiat money, a pure commodity standard, and a commodity standard with competitive banking.

A note before we proceed. All of these models discuss the stock supply of money. There is no time dimension associated with the money supply; it's just a lump of stuff. In contrast, when we model the supply of pizza or laptops or sports coats, we describe how many of these items *per unit time* (weeks, months, years) firms offer. We call these *flow* supplies. The underlying economics is often the same, but it's important to distinguish stocks from flows.

Model One: Central Banking with Fiat Money
"Fiat" is Latin for "Let it be done." We use it in English to describe a proclamation or decree. Hence

fiat money is money because the government says it is. The most common form of fiat money is unbacked paper. Some economists hold that fiat money is backed by the prospect of future government budget surpluses, but this is not widely accepted.

Governments typically issue fiat money through their central banks. In the United States, the narrowest measure of the money supply consists of Federal Reserve liabilities: physical currency plus private bank deposits held at the Fed. We call this the "monetary base." More expansive measures include money created by private financial institutions, including checking accounts, savings accounts, and money market mutual funds.

What is the "price" of fiat money? Almost by definition, the market value of fiat money's underlying commodity (paper and ink) is near zero. Instead, what matters is its use in exchange. Money's price depends on its purchasing power. The higher prices are *in general*, the lower is money's price, and vice versa. The inflation we're currently experiencing means money is losing its purchasing power, and hence its price is falling, much faster than usual.

Central banks aren't constrained by profitability. They can make the monetary base whatever they want. Private banks are constrained by profitability, but they make their financial intermediation decisions (which augment the money supply) based on asset returns and interest rates.

Under central banks' fiat money, there is no functional relationship between the price of money and the supply of money. A given quantity of money is compatible with *any* value for money's purchasing power. In economics jargon, we say the money supply is *perfectly inelastic*. The quantity of money

is supply-determined, while its price—alternatively, purchasing power—is demand-determined. Graphically, with the quantity of money on the horizontal axis and the price of money on the vertical axis, the supply of money is a vertical line.

Model Two: Pure Commodity Money

In some ways, commodity money is the opposite of fiat money. A gold coin standard, with minted gold as money, is the most obvious example. A fiat money's exchange value greatly exceeds its cost of production. In contrast, a commodity money's exchange value approximates its cost of production. If these two values markedly diverged, crafty entrepreneurs would immediately perceive an arbitrage opportunity: buy the commodity-money where its price is low and sell it where its price is high.

The price of commodity money is just the relative price of the commodity. Again referencing a gold coin standard, money's price is the relative price of gold to other goods. Unlike with fiat money, there is a functional relationship between the price of a commodity money and the quantity of the commodity money supplied. When the relative price of gold increases, gold miners step up production, and those who own non-monetary gold (jewelry, for example) may turn it into monetary gold. Now we get the familiar increasing relationship between price and quantity supplied: All else equal, a higher *relative* price of gold means a larger quantity supplied of monetary gold.

There's more to it than this, of course. A fuller picture would need to take into account the feedback effects between gold mining and gold minting. But the basic relationship, in the form of a nice, familiar, upward-sloping supply curve, stands.

Model Three: Commodity Money with Competitive Banking

Let's add a competitive banking system on top of Model Two. A large number of banks accept gold deposits in exchange for liabilities denominated in gold. These liabilities include banknotes, redeemable for gold on demand. They also include checking accounts and savings accounts, which probably pay interest and may have some *redemption* conditions.

The key feature of this system is the divergence between the medium of *exchange* and the medium of redemption. Provided the banks are trustworthy, there's no need to lug around physical gold to make transactions. We can just use bank liabilities to buy and sell. Banks naturally acquire large stocks of each others' liabilities and can settle up at regular intervals. Occasionally, we may want to redeem our liabilities for gold, but this is rare.

In this model, financial intermediation creates money. Since everyone uses bank liabilities as money, new bank lending creates money via the fractional-reserve process.

Here's what's neat about this system: Banks will collectively supply as much money as the public wants to hold at the prevailing purchasing power of the redemption medium. If money is denominated in gold, the relative price of gold is still money's price. But because the public treats bank liabilities and gold as near-perfect substitutes, banks are perfectly happy to issue as many liabilities as the public demands. A given price of gold, therefore, is compatible with any quantity of bank-issued money. Economists call this *perfectly elastic* supply. The quantity of money is demand-determined, while the price is supply-determined. Graphically, the supply curve for money is horizontal. It intersects the vertical axis at the gold price.

The Takeaway

We have to be very careful about generalizing across money and banking regimes. Many features of one system don't translate to others. Depending on the "rules of the game," the supply of money responds to the price of money in very different ways. Perhaps it does not respond at all. Perhaps it responds as much as demanded. And perhaps it's somewhere in between.

A full picture of the money market requires modeling demand, too. Putting supply and demand together can determine the sustainable price and quantity and predict how changes in supply or demand (or both!) affect prices and quantities. At least one thing about money is the same as other goods. The economist's toolkit of comparative statics can help us understand how the world works.

– September 9, 2022

Is The Fed Trying To Inflate Away US Debt?

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Inflation has risen for nearly two years now. The Consumer Price Index drifted from 2 to over 4 percent in April 2021. In May 2021 it hit 5 percent, in October 2021 it surpassed 6 percent, and in December 2021 it crossed the 7 percent level. From Feb 2022 through May 2022, the monthly CPI changes were the largest they'd been in decades; in fact, there hadn't been a 1 percent monthly CPI headline change since mid-2008. The same applies for two alternative measures of inflation: the GDP Deflator and the Personal Consumption Expenditure Price Index. All three inflation measures spent years oscillating within narrow ranges, only to rise steadily to multiples of their long-held values between early 2021 and late 2022.

Headline CPI, Personal Consumption Expenditure Price Index, and GDP Deflator, all year-over-year (2012 – present)



(Source: Bloomberg Finance, LP)

In the period after the massive fiscal and monetary programs employed to address the effects of pandemic mitigation measures, officials at the Fed must have been tracking prices and other data points closely. In all likelihood, they were watching more closely than usual. Several times in the summer and early fall of 2021 they publicly addressed the

rising price levels, categorizing them as “transitory.” But no measures, other than assurances of their watchfulness, were undertaken to stem or slow the inflationary upsurge until March of 2022.

The delay in intervention has led to accusations of both incompetence and intentionality. Certainly central bankers face a vast marshaling of barriers ranging from clumsy “tools,” to lag effects, to political pressures and beyond, impacting the crafting of effective monetary policies. It seems fairer to summarize those difficulties as unavoidable aspects of the insurmountable barriers associated with central planning rather than simple ineptitude, but that is a separate issue.

The latter explanation tends to be associated with the idea of the Fed or central banks more broadly as saboteurs. Rather than overmatched technocrats, central bankers are seen as cartoon villains, imbued with expert skills and inspired by tireless malevolence. To increase the population’s dependence upon government programs, to more deeply entrench elites, or for any of a number of other alleged purposes, the story goes, the Federal Reserve and other central banks are purposely permitting or even causing inflation to rise. Ironically, as in the case of 9/11 conspiracy theories, crediting governments with the ability to execute massive, intricate, perfectly timed and executed plots—with the purported involvement of thousands of people keeping secrets for months or years—is an unabashed endorsement of the competence of bureaucrats and the feasibility of central planning.

A more reasonable explanation is that the Fed chose to let inflation run up a bit in order to accelerate the recovery from COVID lockdowns

and stay-at-home orders. They overshot, though, and the increase in the general price level happened faster than expected. Additionally, those increases were difficult to distinguish, first, against broad relative price increases associated with widespread supply chain problems (late 2021), later amid price increases following the invasion of Ukraine by Russia (early 2022). And while there is now an effort to get prices back under control, the erosion of the \$31 trillion pile of US debt is an unintended, but welcome, side effect.

Inflation is an acknowledged, historically vindicated salve for high and rising government debt levels. Historically, though, the effectiveness of debt debasement via inflation has depended upon several variables. Obviously the level and persistence of inflation itself is the foremost factor. Another is the structure of the debt as measured by weighted average maturity (WAM). The WAM of US government debt has fallen from roughly 70 months (5.8 years) before the pandemic to about 65 months (5.4 years) presently. Our debt is therefore highly concentrated at the short end of the yield curve. Rising inflation tends to impact longer term debt more than short term debt, but some corrosive effect of decreased purchasing power will manifest in short-term government securities.

If the Treasury were to start issuing longer-term debt in noticeably longer maturities, pushing the WAM of US public debt off into the future, investors would note and likely avoid the heightened inflation vulnerability of those newer issues. Hilscher, Raviv, and Reis (2014) note the role that financial repression has played in previous episodes where debt was inflated away in real terms.

One way to increase maturity, albeit ex post, is to [bring about a] situation where the private sector is essentially forced to hold long-term debt at below-market interest rates ... [I]f

holders of the debt are forced to receive as payment required reserves that must be held at the central bank for N years, then this is equivalent to an ex post maturity extension. If N is as long as 10 years, then 2.5 percent more inflation on average over the next 30 years—which previously lowered the real value of debt by 3.7 percent—now lowers it by 23 percent of GDP, almost half the value of privately held debt. Of course, the side effects of such extreme repression on financial development might well be large.

What does it all amount to? Superficially, it decreases the debt to GDP ratio and makes the debt service more manageable. But lenders are fully aware that their interest payments are coming in more debased currency than was lent, which may impact their willingness to extend their outstanding loans or lend more in the future. In the current political environment, melting debt via inflation is less likely to be undertaken as fiscal housecleaning than as a measure to facilitate incurring more debt. For the government, a more pressing issue will emerge if disinflation takes longer than expected: investors will expect higher interest rates on future bonds or other securities, potentially setting up problems down the road.

**US Treasury Public Debt outstanding and US GDP
quarter-over-quarter (2012 – present)**



(Source: Bloomberg Finance, LP)

More importantly, though, debt deflation via inflation threatens the economic health of citizens no less than three times in one fell swoop. Under such a policy, not only do our taxes go toward repaying debt, our purchasing power is expressly whittled away to decrease the real value of the outstanding debt load. And if the effects are successful, the government can and likely will take on more debt as a consequence. And for those troubles, citizens face a rapidly increasing chance of a recession in the next year or two. Globally, after some amount of time, demand for the US dollar would likely suffer.

The ease with which the concept is expressed, as if debt were an ice cube left on a driveway on a summer day, betrays the numerous costs associated with such a scheme. And that holds whether the undertaking is intentional or not.

– September 28, 2022

America's Other Constitution

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On this Constitution Day 2022, I would, if I could, smack upside the head the first person who touted the notion that America's written Constitution is better than Great Britain's unwritten constitution. Why? Because America *also* had an unwritten constitution, one as important as its written counterpart, that unfortunately faded from view until its eventual quiet murder by Progressives and New Dealers. The key question Americans face today is whether they have the will to revivify both their constitutions before it is too late.

When Americans speak of "The Constitution," they refer to the document written in Philadelphia in 1787 and subsequently amended. They remain aware of the existence of state constitutions but rightly understand that they can be no more illiberal than the federal document allows, as interpreted by the US Supreme Court (SCOTUS), the final arbiter of the constitutionality of statutes and government policies.

Long forgotten, though alluded to in The Constitution's all-important Preamble, the Ninth Amendment, the Declaration of Independence, and other founding documents, is America's second, unwritten constitution. It consists of natural rights not explicitly enumerated in the Constitution, natural rights so fundamental to liberty that the Framers hoped that no republican government would dare to erode or question them. They were wrong.

Although vibrant and well-understood in the eighteenth century, America's unwritten constitution slowly eroded and disappeared entirely by the early twentieth century. The degradation of America's unwritten natural rights constitution made the New Deal possible and late-New-Deal jurisprudence wiped away its last vestiges. In *Wickard* (1942), for

example, SCOTUS unanimously upheld the federal government's power to prevent a farmer in Ohio from planting wheat to feed his own family.

Fear that some of its key components might one day be challenged led to the unwritten constitution's partial codification and ratification as the Bill of Rights. Today, many of those first ten amendments to the Constitution are being ignored, or at least challenged, despite clear mandates that they "shall not be infringed." But they remain more palpable than even more fundamental rights that have almost disappeared.

To fully explore the contents of the unwritten constitution would require a book-length treatment, and one that takes natural rights much more seriously than Christopher G. Tiedeman's 1890 *The Unwritten Constitution of the United States: A Philosophical Inquiry into the Fundamentals of American Constitutional Law*. Tiedeman reduced natural law to "freedom from all legal restraint that is not needed to prevent injury to others; a right to do any thing that does not involve a trespass or injury to others." But simply recognizing a "freedom from needless restraint" draws most government regulation into question and reifies the spirit of the unwritten constitution, including three crucial natural rights:

- **Self-ownership** shall not be infringed, except by virtue of status of birth mother, capture in war, or due conviction of a crime. The Thirteenth Amendment wiped out the first two exceptions, which had always been contested. Self-ownership renders Americans free from slavery, economically and politically. The latter implies full bodily autonomy, even during emergencies.

- Pursuit of an **occupation of one's own choosing**, on the terms of one's own choosing, shall not be infringed. This would preclude trivial occupational licensing laws, all minimum wage laws, and the use of state power to favor some individuals or businesses over others, even during emergencies.
- **Reliance on markets and other voluntary efforts**, with state power applied to solve perceived social problems only after voluntary means have been tried and found wanting. As my forthcoming book *Liberty Lost* (AIER, 2022) shows, early Americans equated voluntary association with political liberty. Instead of immediately asking what the government could do, they tackled social problems themselves, voluntarily through nonprofit organizations. And they did so even during emergencies, including the Civil War.

"In these days of great social unrest," Tiedeman explained in 1890, "we applaud the disposition of the courts to seize hold of these general declarations of rights as an authority for them to lay their interdict upon all legislative acts which interfere with the individual's natural rights, even though these acts do not violate any specific or special provision of the [written] Constitution."

But even before Tiedeman wrote, high courts were already rejecting the notion that they should look to "principles outside of the Constitution, under which such [overreaching] legislation may be condemned." They did so by wrapping the precepts of the unwritten constitution into constitutional rights like due process, broadly construed. In the 1877 case *Bertholf v. O'Reilly* (74 N.Y. 509), for example, the New York Court of Appeals decided that "the right to life includes **the right of the individual to his body** in its completeness and without dismemberment; the right to liberty, the right to exercise his

faculties and to follow a **lawful avocation** for the support of life [emphases added]."

The wrapping tactic allowed jurists to cite text to justify their decisions, which at first continued in line with the views of the Founders. In the above-referenced case, for example, the Court clearly stated that taxation had to be for "a public purpose," so it was clearly unconstitutional for governments to transfer property from one citizen to another. When Progressives and New Dealers later managed to twist key concepts like public purpose, public health, and due process, however, the increasingly forgotten unwritten constitution was no longer strong enough to protect fundamental natural rights from government encroachment.

With jurisprudence no longer anchored to fundamental precepts, one successful Progressive incursion simply served as precedent for the next, which allowed another, and yet another in a seemingly never ending stream. A century later, the nation's authoritarian government would be unrecognizable to the Framers and Founders. Furtive interference with free speech, unscientific climate, mask, vaccine, and shutdown mandates, massive redistributions of wealth to cronies foreign and domestic, the flaunting of disfavored-but-unrepealed laws, and other unpunished abominations were the stuff of their nightmares.

The unwritten constitution remains a dead letter, and the Bill of Rights, even the once-sacrosanct First Amendment, suffers daily assault. I fear that someday soon Constitution Day will have to be folded into Memorial Day. To prevent that horrible outcome, Americans must strenuously reassert their natural right to be left to do as they wish unless their behaviors demonstrably injure other Americans. Even then they should be allowed to pursue voluntary solutions before governments may constitutionally intercede.

– September 17, 2022



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