

RESEARCH REPORTS

Volume LXXXIII

November 2022

published by

AMERICAN INSTITUTE *for* ECONOMIC RESEARCH

RESEARCH REPORTS

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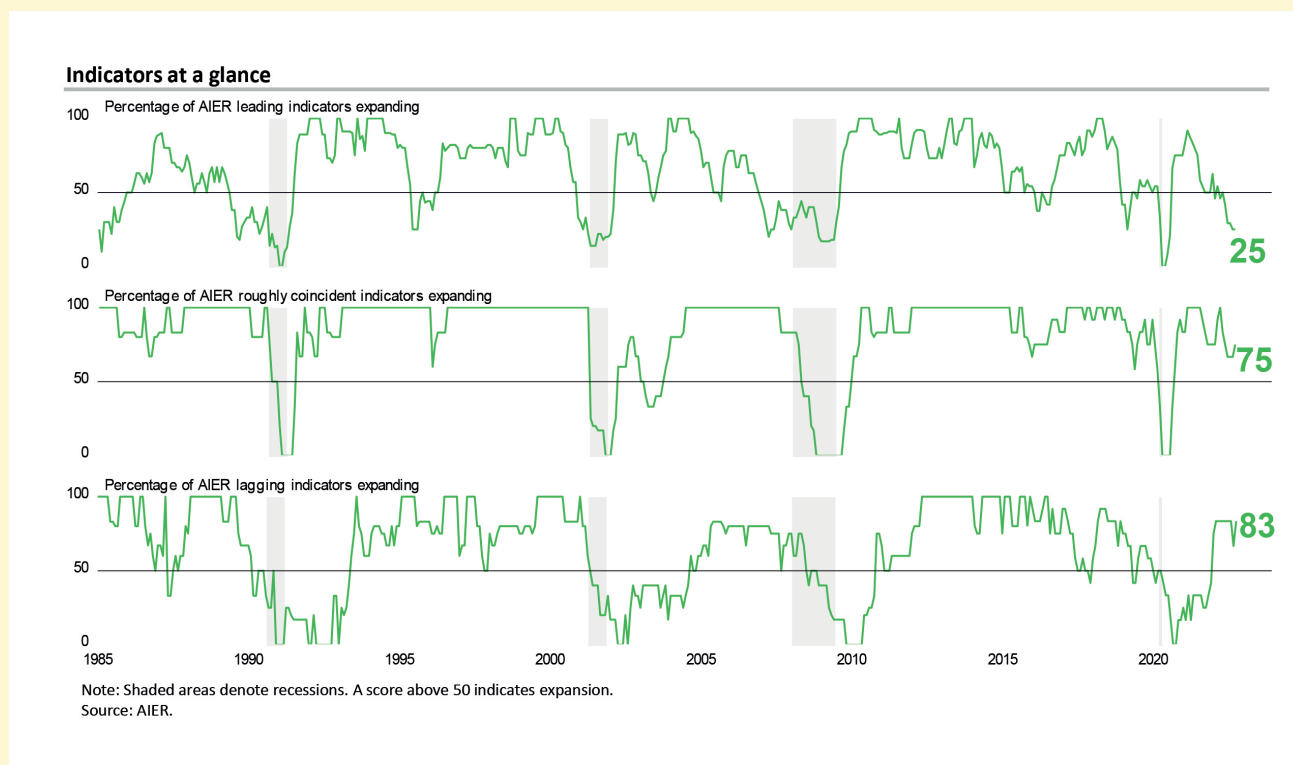
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BUSINESS
CONDITIONS
MONTHLY

Robert Hughes

SENIOR RESEARCH FELLOW

AIER Leading Indicators Index Remains Well Below Neutral



Summary

AIER's Leading Indicators Index held at 25 in October. The latest result is the fifth consecutive month below the neutral 50 threshold. The low readings are consistent with weakness in the economy and significantly elevated risks for the outlook.

The first estimate of third-quarter real gross domestic product (GDP) came in at a 2.6 percent annualized growth rate, following rates of -1.6 percent in the first quarter and -0.6 percent for the second quarter. Real final sales to private domestic purchasers, about 88 percent of real GDP and arguably a better measure of private domestic demand, has shown greater resilience, with growth having stayed positive despite declines in real GDP. However, domestic demand growth has slowed significantly, from a 2.6 percent pace in the fourth quarter of 2021 to 2.1 percent in the first quarter, 0.5 percent in the second quarter, and just 0.1 percent in the third quarter.

Consumers remain the cornerstone of the U.S. economy with real consumer spending accounting for about 70 percent of real GDP and about 80 percent of real domestic demand. For consumers, the labor market remains tight with payrolls continuing to expand (though the pace appears to be slowing), job openings at a high level, and layoffs hovering near lows. The solid labor market supports positive consumer attitudes but that is offset by high inflation and rapid interest rate increases that threaten future economic growth.

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 Holds at 25 in October, Signaling Significant Risks

In the October update, the AIER Leading Indicators index remained at 25. The October result is down 67 points from the March 2021 high of 92. Excluding the lockdown recession of 2020, it matches the lowest level since the recovery from the 2008-2009 recession. With the latest reading holding well below the neutral 50 threshold, the AIER Leading Indicators Index is signaling economic weakness and significantly elevated outlook risks.

Two leading indicators had offsetting signal changes in October. The real retail sales indicator weakened from a neutral trend to a negative trend. This indicator has been volatile recently, changing signals six times in the last twelve months. Indicators often become volatile around inflection points.

The second indicator to change trend in October was the real new orders for consumer goods indicator. It reversed its September weakening, improving from a neutral to a positive trend and offsetting the deterioration in the real retail sales indicator. This indicator has also been volatile recently, changing trend in each of the last three months. Given the erratic performance of real core retail sales and rising real manufacturing and trade inventories (an AIER lagging indicator), it's not surprising to see new orders become volatile.

Among the 12 leading indicators, three were in a positive trend in October, nine were trending lower, and none were trending flat or neutral.

The Roughly Coincident Indicators index improved in October, coming in at 75 following three consecutive months at 67. Before the three-month run at 67, the indicator posted a 75 in June, 83 in May, and a perfect 100 in April. The Roughly Coincident Indicators Index has been above the neutral 50 threshold since September 2020.

Three indicators changed signal last month. Real manufacturing and trade sales improved from

a negative trend to a neutral trend. This indicator had been in a negative trend for five consecutive months. The real personal income excluding transfers indicator improved to a positive trend from a neutral trend in September. The Conference Board Consumer Confidence in the Present Situation indicator weakened to a negative trend from a neutral trend in the prior month.

In total, four roughly coincident indicators – nonfarm payrolls, employment-to-population ratio, real personal income excluding transfers, and industrial production – were trending higher in October while the real manufacturing and trade sales indicator was in a neutral trend, and the Conference Board Consumer Confidence in the Present Situation indicator was in a negative trend. Given the poor performance of 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 rose to 83 in October after 67 in September and 83 for seven consecutive months from February through August. 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 improved from neutral to favorable trends. In total, five indicators – the duration of unemployment indicator, the real manufacturing and trade inventories indicator, the composite short-term interest rates indicator, the 12-month change in the core Consumer Price Index indicator, and the commercial and industrial loans indicator – were in favorable trends, and one indicator, real private nonresidential construction, had an unfavorable trend.

Overall, the AIER Leading Indicators Index remained well 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. Particularly important for the outlook is the strength of the labor market. A deeper and sharper economic contraction becomes more probable if significant declines in payrolls 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.

Solid Third Quarter GDP Number Masks Pockets of Weakness

Real gross domestic product rose at a 2.6 percent annualized rate in the third quarter versus a 0.6 percent rate of decline in the second quarter and -1.6 pace in the first quarter. Over the past four quarters, real gross domestic product is up 1.8 percent.

Real final sales to private domestic purchasers, about 88 percent of real GDP and a key measure of private domestic demand, has shown greater resilience, with growth having stayed positive despite declines in real GDP. However, growth has slowed significantly, from a 2.6 percent pace in the fourth quarter of 2021 to 2.1 percent in the first quarter, 0.5 percent in the second quarter, and just 0.1 percent in the third quarter. Over the last four quarters, real final sales to private domestic purchasers are up 1.3 percent.

Real GDP and real final sales to private domestic purchasers are close to their 10-year trends. The data shown in the current report are based on incomplete information and will likely be revised in subsequent releases.

Headline numbers like GDP don't provide a complete picture. Despite a solid result for real GDP growth in the third quarter, performance among the various components of GDP were mixed. Among the components, real consumer spending overall rose at a 1.4 percent annualized rate and contributed a total

of 0.97 percentage points to real GDP growth. Over the last 40 years, consumer spending has posted average annualized growth of about 3.0 percent and contributed an average of 2.0 percentage points to real GDP growth.

Consumer services led the growth in overall consumer spending in the third quarter, posting a 2.8 percent annualized rate, adding 1.24 percentage points to total growth. Durable-goods spending fell at a 0.8 percent pace, the second consecutive decline, subtracting 0.07 percentage points while nondurable-goods spending fell at a -1.4 percent pace, the third consecutive drop, subtracting 0.20 percentage points.

Business fixed investment increased at a 3.7 percent annualized rate in the third quarter of 2022, adding 0.49 percentage points to final growth. Intellectual-property investment rose at a 6.9 percent pace, adding 0.36 points to growth while business equipment investment rose at a 10.8 percent pace, adding 0.54 percentage points. However, spending on business structures fell at a 15.3 percent rate, the sixth decline in a row, subtracting 0.41 percentage points from final growth.

Residential investment, or housing, plunged at a 26.4 percent annual rate in the third quarter, following a 17.8 annualized fall in the prior quarter. The drop in the third quarter was the sixth consecutive decline and subtracted 1.37 percentage points from third quarter growth.

Businesses added to inventory at a \$61.9 billion annual rate (in real terms) in the third quarter versus accumulation at a \$110.2 billion rate in the second quarter. The slower accumulation reduced third-quarter growth by 0.70 percentage points. That followed a sizable 1.91 deduction from second quarter real GDP growth that more than accounted for the 0.6 percent decline in the headline result. Swings in inventory accumulation often add significant volatility to headline real GDP.

Exports rose at a 14.4 percent pace while imports fell at a 6.9 percent rate. Since imports count as a negative in the calculation of gross domestic product, a drop in imports is a positive for GDP growth, adding 1.14 percentage points in the third quarter. The rise in exports added 1.63 percentage points. Net trade, as used in the calculation of gross domestic product, contributed 2.77 percentage points to overall growth, helping to hide the weakness in domestic demand.

Government spending rose at a 2.4 percent annualized rate in the third quarter compared to a 1.6 percent pace of decline in the second quarter, adding 0.42 percentage points to growth.

Consumer price measures showed another rise in the third quarter, though the pace decelerated. The personal-consumption price index rose at a 4.2 percent annualized rate, below the 7.3 percent pace in the second quarter and the 7.5 percent rate in the first quarter. From a year ago, the index is up 6.3 percent. However, excluding the volatile food and energy categories, the core PCE (personal consumption expenditures) index rose at a 4.5 percent pace versus a 4.7 percent increase in the second quarter and 5.6 percent in the first quarter. That is the slowest pace of rise since the first quarter of 2021. From a year ago, the core PCE index is up 4.9 percent.

Payroll Growth Continues, but the Pace Is Slowing

Total nonfarm payrolls posted a 261,000 gain in October versus a 315,000 rise in September (revised up by 52,000), while August had an increase of 292,000 (revised down by 23,000). Over the last three months, the average gain is 289,300 versus a 12-month average of 441,900.

Excluding the government sector, private payrolls posted a gain of 233,000 in October following the addition of a net 319,000 jobs in September. The average monthly gain over the 22 months since

January 2021 was 461,000. However, the monthly increases appear to be slowing. Over the 14 months from January 2021 through February 2022, the average monthly rise was 535,000; for the five months from March 2022 through July 2022, the average was 376,000; and over the last three months, the average has dropped to 262,000.

Though the net gains are decelerating, the gains in October were widespread. Within the 233,000 increase in private payrolls, private services added 200,000 versus a 12-month average of 355,800 while goods-producing industries added 33,000 versus a 12-month average of 64,800.

Within private service-producing industries, education and health services increased by 79,000 (versus a 77,300 twelve-month average), business and professional services added 39,000 (versus 72,800), leisure and hospitality added 35,000 (versus 96,500), and wholesale trade gained 14,600 (versus 17,200).

Within the 33,000 addition in goods-producing industries, durable-goods manufacturing rose by 23,000, nondurable-goods manufacturing expanded by 9,000, construction added 1,000, and mining and logging industries was unchanged.

While a few of the services industries dominate actual monthly private payroll gains, monthly percent changes paint a different picture. Gains were more evenly distributed, as ten industries gained more than 0.1 percent, and six of those posted a gain of more than 0.2 percent.

Average hourly earnings for all private workers rose 0.4 percent in October, above the 0.3 percent September gain. That puts the 12-month gain at 4.7 percent, down from a recent peak of 5.6 percent in March. Average hourly earnings for private, production and nonsupervisory workers rose 0.3 percent for the month and are up 5.5 percent from a year ago, down from 6.7 percent in March.

The average workweek for all workers held for

the fifth consecutive month at 34.5 hours in October while the average workweek for production and nonsupervisory remained at 34.0 hours.

Combining payrolls with hourly earnings and hours worked, the index of aggregate weekly payrolls for all workers gained 0.6 percent in October and is up 8.0 percent from a year ago; the index for production and nonsupervisory workers rose 0.4 percent and is 8.9 percent above the year ago level.

The total number of officially unemployed was 6.059 million in October, a rise of 306,000. The unemployment rate rose 0.2 percentage points to 3.7 percent, reversing the 0.2 percentage point drop in September, while the underemployed rate, referred to as the U-6 rate, decreased by 0.1 percentage points to 6.8 percent in October. Both measures have been bouncing around in a flat trend over the last few months.

The employment-to-population ratio, one of AIER's Roughly Coincident indicators, came in at 60.0 percent for October, down 0.1 from September and still significantly below the 61.2 percent in February 2020.

The labor force participation rate fell by 0.1 percentage point in October to 62.2 percent. This important measure has been trending flat recently, matching the 62.2 percent reading in January 2022. Labor force participation is still well below the 63.4 percent of February 2020.

The total labor force came in at 164.667 million, down 22,000 from the prior month and nearly matching the February 2020 level. If the 63.4 percent participation rate were applied to the current working-age population of 264.535 million, an additional 3.04 million workers would be available.

The October jobs report shows total nonfarm and private payrolls posted additional albeit slower gains than recent prior periods. Continued gains in employment are a positive sign, providing support to consumer attitudes and consumer spending.

However, concerns about future payroll gains continue in light of aggressive Fed interest rate increases. Still, the level of open jobs remains high and initial claims for unemployment insurance remain low, suggesting the labor market remains tight.

Weekly Initial Claims Suggest the Labor Market Remains Tight

Initial claims for regular state unemployment insurance fell by 1,000 for the week ending October 29th, coming in at 217,000. The previous week's 218,000 was revised up from the initial estimate of 217,000. Claims have fallen in eight of the last 12 weeks, but the changes over the last five weeks have been small. When measured as a percentage of nonfarm payrolls, claims came in at 0.136 percent for September, down from 0.160 in August but above the record low of 0.117 in March. Overall, the level of weekly initial claims for unemployment insurance remains very low by historical comparison.

The four-week average fell to 218,750, down 500 from the prior week. The four-week average peaked in early August and trended lower through the end of September but has risen slightly since the low. Overall, the data continue to suggest a tight labor market.

The number of ongoing claims for state unemployment programs totaled 1.224 million for the week ending October 15th, an increase of 26,543 from the prior week. State continuing claims had been trending higher from mid-May through the end of July but are now trending lower over the last few weeks.

The latest results for the combined Federal and state programs put the total number of people claiming benefits in all unemployment programs at 1.251 million for the week ended October 15th, an increase of 28,929 from the prior week.

Consumer Expectations for the Future Remained Weak in October

The final October results from the University of Michigan Surveys of Consumers show overall consumer sentiment was little changed from September and remains at very low levels. The composite consumer sentiment increased to 59.9 in October, up from 58.6 in September. The index hit a record low of 50.0 in June, down from 101.0 in February 2020 at the onset of the lockdown recession. The increase for October totaled just 1.3 points or 2.2 percent, leaving the index about 10 points above the record low. The index remains consistent with prior recession levels.

The current-economic-conditions index rose to 65.6 versus 59.7 in September. That is a 5.9-point or 9.9 percent increase for the month. This component has had a notable bounce from the June low of 53.8 but remains consistent with prior recessions.

The second component — consumer expectations, one of the AIER leading indicators — fell 1.8 points to 56.2. This component index posted a strong bounce in August but was unchanged in September and fell slightly in the most recent month. The index is still consistent with prior recession levels.

According to the report, “With sentiment sitting only 10 index points above the all-time low reached in June, the recent news of a slowdown in consumer spending in the third quarter comes as no surprise.” The report adds, “This month, buying conditions for durables surged 23% on the basis of easing prices and supply constraints. However, year-ahead expected business conditions worsened 19%. These divergent patterns reflect substantial uncertainty over inflation, policy responses, and developments worldwide, and consumer views are consistent with a recession ahead in the economy.” Furthermore, “While lower-income consumers reported sizable gains in overall sentiment, consumers with considerable stock market and housing wealth exhibited

notable declines in sentiment, weighed down by tumult in those markets. Given consumers' ongoing unease over the economy, most notably this month among higher-income consumers, any continued weakening in incomes or wealth could lead to further pullbacks in spending...”

The one-year inflation expectations rose in October, rising to 5.0 percent. The jump follows a string of declines over the five months through September after hitting back-to-back readings of 5.4 percent in March and April.

The five-year inflation expectations also ticked up, coming in at 2.9 percent in October. Despite the uptick, the result is well within the 25-year range of 2.2 percent to 3.4 percent. The report states, “The median expected year-ahead inflation rate rose to 5.0%, with increases reported across age, income, and education. Last month, long run inflation expectations fell below the narrow 2.9-3.1% range for the first time since July 2021, but since then expectations have reverted to 2.9%. Uncertainty over inflation expectations remains elevated, indicating that inflation expectations are likely to remain unstable in the months ahead.”

Consumer Confidence Fell in October

The Consumer Confidence Index from The Conference Board fell in October following two consecutive monthly gains. The composite index decreased by 5.3 points, or 4.9 percent, to 102.5. The index is down 8.2 percent from September 2021 and 20.5 percent from the cycle peak of 128.9 in June 2021. Both components declined in October.

The expectations component dropped 1.4 points, or 1.8 percent, to 78.1 while the present-situation component — one of AIER's Roughly Coincident Indicators — sank 11.3 points, or 7.5 percent, to 138.9. The present situation index is off 4.5 percent over the past year while the expectations index is down 12.2 percent from a year ago. The present

situation index remains at a historically favorable level. However, the sharp decline in October suggests economic growth may be slowing, while the expectations index remains consistent with prior recessions.

Within the expectations index, all three components weakened versus September. The index for expectations for higher income gained 0.6 points to 18.9, but the index for expectations for lower income rose 1.3 points, leaving the net (expected higher income - expected lower income) down 0.7 points to 3.8.

The index for expectations for better business conditions rose 0.6 points to 19.2, while the index for expected worse conditions rose 1.4 points, leaving the net (expected business conditions better - expected business conditions worse) down 0.8 points at -4.1.

The outlook for the jobs market also deteriorated in October as the expectations for more jobs index increased 2.4 points to 19.8, but the expectations for fewer jobs index rose by 3.0 points to 20.8, putting the net down 0.6 points to -1.0.

Current business conditions and current employment conditions fell for the present situation index components. The net reading for current business conditions (current business conditions good - current business conditions bad) was -6.5 in October, down from -0.2 in September and the weakest result since July. Current views for the labor market saw the jobs hard to get index increase to 12.7 while the jobs plentiful index fell 4.0 points to a still solid 45.2. The net index (jobs hard to get – jobs plentiful) dropped 5.6 points to 32.5.

Inflation expectations ticked up slightly, rising 0.2 percentage points to 7.0 percent in October from 6.8 percent in September. The rise was largely a function of higher food and gasoline prices. Notably, the short-term inflation expectations remain below the recent peaks of 7.9 percent in March and June 2022. Furthermore, while the pattern of movements

between The Conference Board measure and a similar measure from the University of Michigan Survey of Consumers, the overall level from the Michigan survey is much lower (though still elevated), and importantly, the longer-term inflation expectations survey from Michigan remains well anchored and consistent with results seen over the last 25 years.

CAPITAL MARKET PERFORMANCE

(Percent change)

	October	Latest 3M	Latest 12M	Calendar Year			Annualized		
				2021	2020	2019	3-year	5-year	10-year
Equity Markets									
S&P 1500	8.2	-6.0	-15.7	26.7	15.8	28.3	8.4	8.2	10.5
S&P 500 - total return	8.1	-5.9	-14.6	28.7	18.4	31.5	10.2	10.4	12.8
S&P 500 - price only	8.0	-6.3	-15.9	26.9	16.3	28.9	8.4	8.5	10.6
S&P 400	10.4	-3.2	-12.9	23.2	11.8	24.1	7.6	5.8	9.5
Russell 2000	10.9	-2.0	-19.6	13.7	18.4	23.7	5.7	4.2	8.5
Dow Jones Global Large-Cap Index	5.4	-8.6	-21.8	16.2	14.7	23.8	2.8	3.3	5.8
Dow Jones Global Large-Cap ex-U.S. Index	2.7	-10.6	-26.3	4.9	8.8	18.2	-3.8	-2.8	0.8
STOXX Europe 600 Index	6.3	-6.0	-13.3	22.2	-4.0	23.2	1.3	0.8	4.3
Bond Markets									
iShares 20-plus Year Treasury Bond ETF	-6.2	-18.2	-34.9	-6.0	16.4	11.5	-12.0	-5.0	-2.5
iShares AAA - A Corporate Bond Fund	-1.4	-10.3	-20.7	-4.2	7.1	9.1	-6.6	-3.3	NA
Commodity Markets									
Gold	-2.2	-7.2	-7.8	-4.0	24.8	18.7	2.7	5.2	-0.5
Silver	0.8	-4.5	-20.2	-12.8	46.8	16.7	2.0	2.6	-5.1
Refinitiv CoreCommodities CRB total return index	2.5	-5.4	16.9	38.5	-9.3	11.8	16.5	9.2	0.0

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

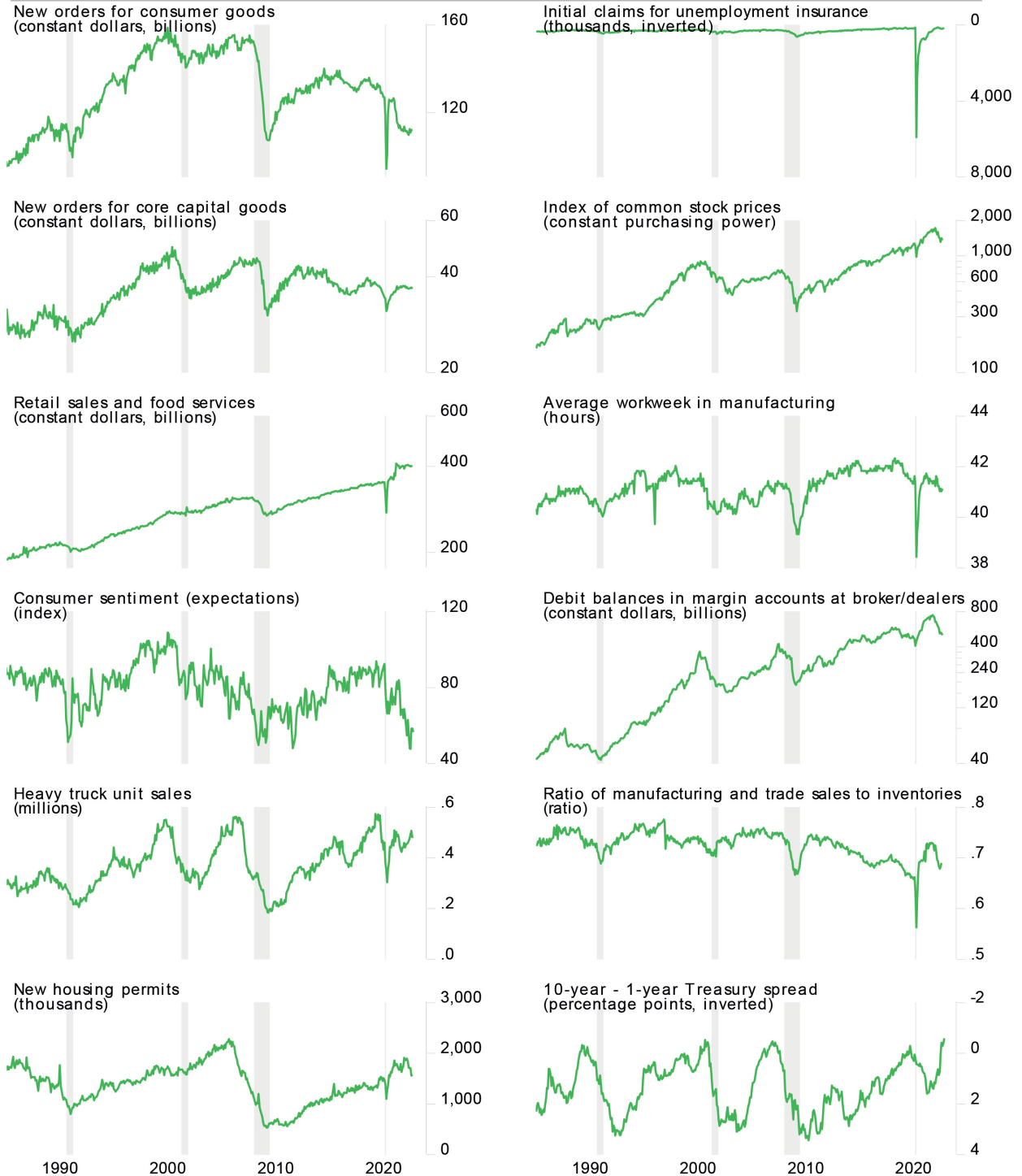
CONSUMER FINANCE RATES

(Percent)

	October	Latest 3M	Latest 12M	Average for Year			Average over Period		
				2021	2020	2019	3-year	5-year	10-year
30-yr. fixed mortgage	6.1	5.6	4.4	3.0	3.1	3.9	3.6	3.8	3.9
15-yr. fixed mortgage	5.4	4.8	3.7	2.3	2.6	3.4	2.9	3.2	3.2
5-yr. adjustable mortgage	4.9	4.5	3.5	2.6	3.1	3.6	3.1	3.4	3.2
48-month new car loan	5.5	5.5	5.0	5.1	5.1	5.4	5.1	5.1	4.7

Sources: Bankrate, Federal Reserve.

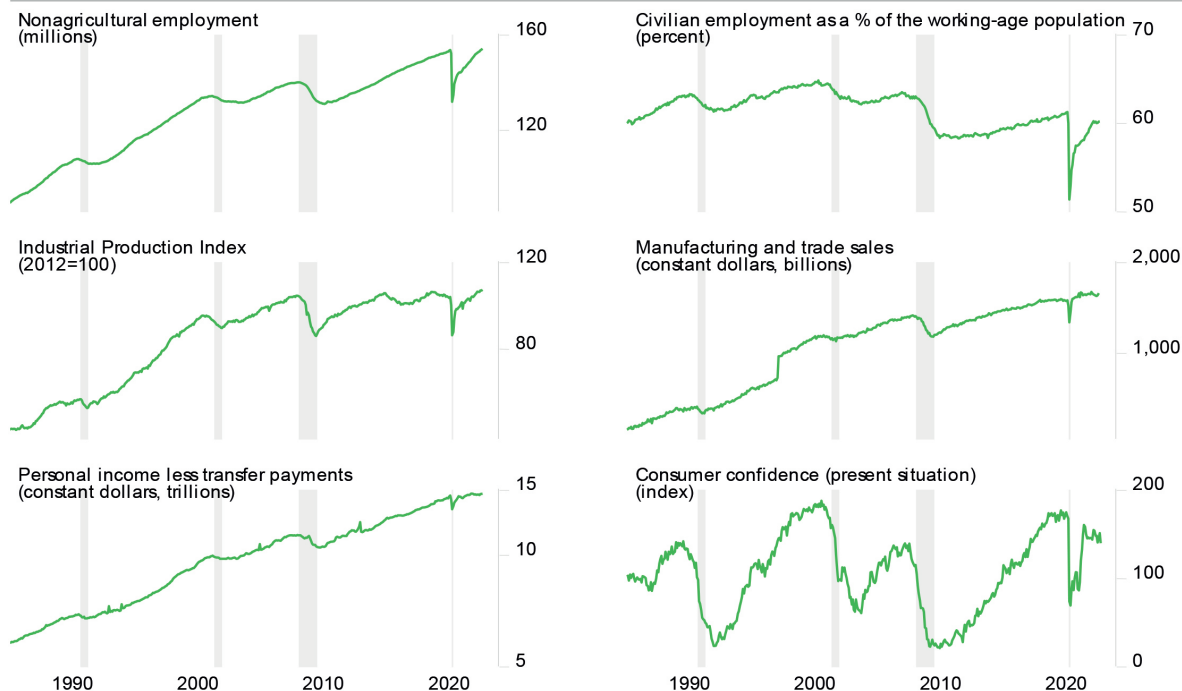
LEADING INDICATORS (1985 - 2022)



Note: Shaded areas denote recessions.

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

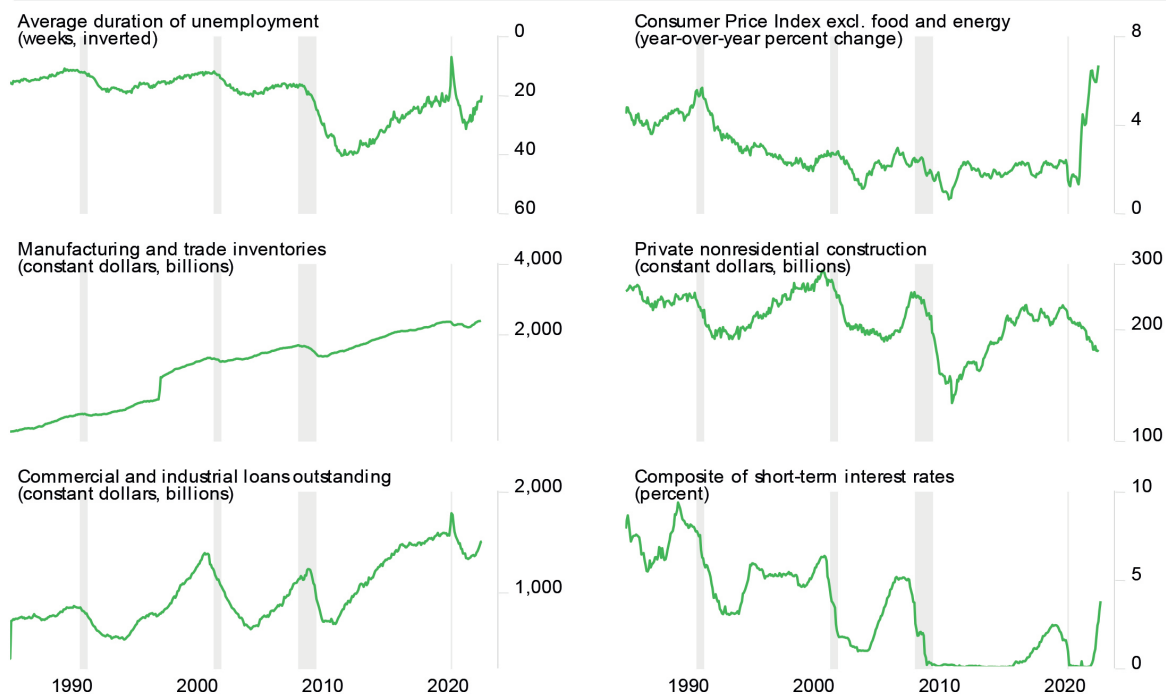
ROUGHLY COINCIDENT INDICATORS (1985 - 2022)



Note: Shaded areas denote recessions.

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

LAGGING INDICATORS (1985 - 2022)



Note: Shaded areas denote recessions.

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

U.S. Receives Lowest Economic Freedom Ranking Since 1975

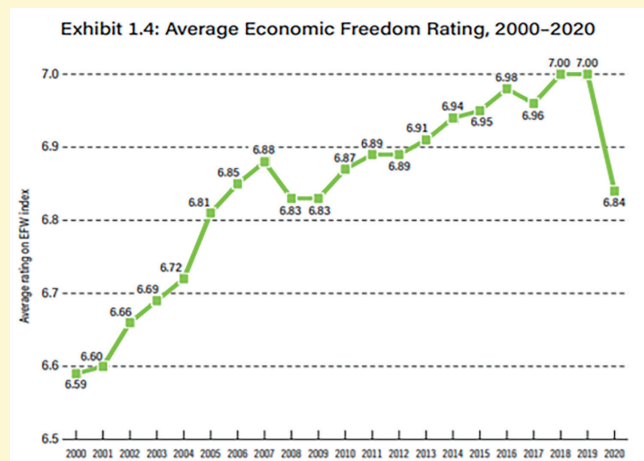
VANCE GINN

Contributor

The Fraser Institute recently released the 2022 Economic Freedom of the World (EFW) Report, reflecting data and rankings for 2020. The findings show that economic freedom in the U.S. fell to its lowest level since 1975, from 6th place to 7th. Although all countries in the report were negatively affected in terms of economic freedom by the COVID-19 pandemic and subsequent shutdowns. The U.S. decline is considerable and indicative of pressing problems that will continue to erode our liberty and prosperity if left unresolved.

Thankfully, the problems that put us here also point to the solutions that can propel us forward into prosperity.

1. Aggressive Shutdowns



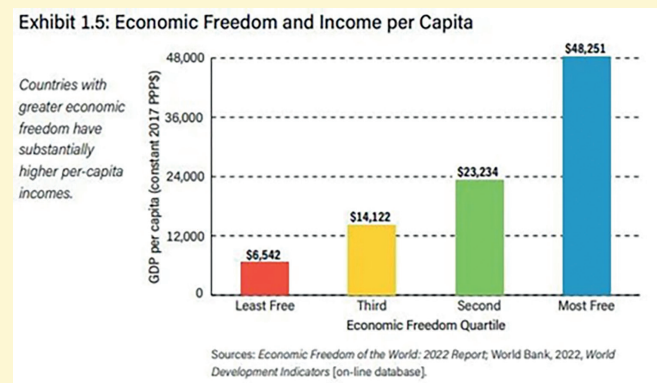
During the peak of the pandemic-related shutdowns, the EFW rating fell to its lowest level since 2009, from the depths of the Great Recession.

Entrepreneurs were sidelined, small businesses deemed “non-essential,” and many Americans sent

home from work, reducing economic freedom and opportunities to quickly overcome the government-imposed dire situation.

I recently interviewed Dr. Robert Lawson, founding co-author of the EFW report and Clinical Professor at Southern Methodist University’s Bridwell Institute, about these findings.

“The income per capita in the top countries [in the report] is about eight to nine times higher than the lowest-ranking nations,” he explained.



Economic freedom does not significantly affect equality, a common concern among critics, but it does have empirically positive outcomes for prosperity. As Thomas Sowell famously said, “There are no solutions. There are only trade-offs.”

In this case, the temporary health concerns of the public were placed on a pedestal that did not consider long-term prosperity. While vaccines and reopenings may have provided some relief from the pandemic, the massive economic consequences are proving to be much longer and steeper than it seems many policymakers were willing to concede.

Out-of-Control Government Spending

In just five months, we'll be three years out from shutdowns and stay-at-home mandates that continue to negatively affect our economy today. The national deficit of 2020 was more than three times what it was in 2019, which was already bloated at \$1 trillion due to excessive government spending.

At the time, many were convinced this was necessary for getting us through a public health crisis, and they were discouraged from considering the financial consequences these measures could impose. Couple that with the Federal Reserve's more than doubling its balance sheet to \$9 trillion, simply printing money at this point, and the U.S. is enduring its highest inflation rate since 1982.

And now, the Biden Administration discounts the wisdom history can teach us about inflation and instead opts to endorse new, unproven economic schemes like Modern Monetary Theory, which asserts that the Fed should create more money to fund Congress' deficit spending, regardless of how it alters inflation.

It's no wonder, then, that inflation continues to climb, robbing people of their purchasing power. This is theft through inflation.

Change is critical not just for economic output but because "more economic freedom improves indicators of social wellbeing," as Lawson says. With more purchasing power and fewer impeding regulations, Americans can overcome challenging circumstances through work and long-term self-sufficiency, instead of being dependent on government programs that provide short-term payments. But cultivating this change requires creating trust as a culture in communities.

"In rule-based, highly regulated countries, building up trust is much harder," says Lawson, who ventured to Venezuela, Cuba, Russia among other countries, speaking with citizens about how the lack of economic freedom affects their lives as research

for his book *Socialism Sucks*. Without social trust, people don't want to trade. Each new regulation and trade restriction the government passes weakens an individual's ability to bring about change at ground level.

In addition to improving economic freedom, we need more hope in our public discourse. For nearly three years now, Americans have woken up daily to harrowing messages about how they're vulnerable and incapable due to a widespread virus, inflation, supply-chain problems, and more. The common gloom-and-doom narrative has become the norm, leaving the nation yearning for optimism. Optimism sets democracy apart from totalitarianism and is desperately needed today.

The truth of the matter, and the hope it provides, is that there is a solution to this crisis: economic freedom. While the next annual EFW report hits in 2021 will likely reveal an even worse situation for economic freedom, a trend will likely continue given how the Biden administration is pursuing big-government policies that are destroying not only economic and individual liberty, but the American Dream itself.

We need a return to the classical liberalism that has advanced people's livelihoods through capitalism and limited government. Those principles helped set the stage for billions of people to be brought out of extreme poverty, so let's get back to them.

– October 14, 2022

King Dollar's Uncertain Throne

PETER C. EARLE

Research Faculty

Behold, the dollar ascendant! Since June 2021, the greenback has been on a tear, recently reaching levels not seen since July 2002. In a year in which virtually every asset class has been hammered, US dollars (as measured by the DXY Index) are up over 16 percent as of October 1st. In fact, between September 12th and 26th alone it increased by over 5 percent. Because the dollar is the world's reserve currency, and for a significant portion of global trade acts as the unit of account, the effects of the surge are being felt worldwide.

Despite jingoistic overtones, dollar strength brings clear tradeoffs for US citizens. The rapid appreciation of the dollar makes imports to the US cheaper and exports more expensive. So for US consumers, part of the blow currently dealt by inflation is mitigated. But for large firms selling American goods overseas, foreign domestic goods are likely to be more competitively priced. That may lead to declining revenue and job loss among US workers. Some firms choose to price goods sold in foreign markets in local currencies, adjusting prices to maneuver between retaining dollar-based revenue and profit, without suppressing demand. But the current economic environment is creating difficulties beyond those that can be skillfully priced away or hedged with derivatives.



(Source: Bloomberg Finance, LP)

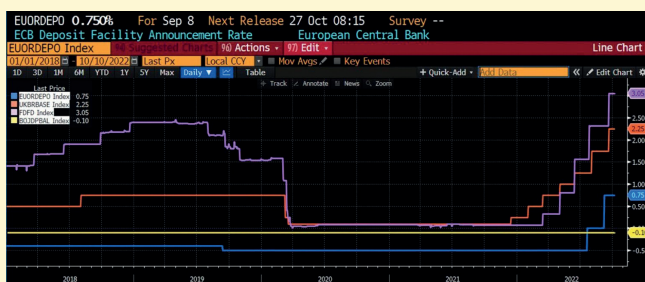
Typically the standard response to a rocketing dollar (or any rapidly appreciating currency) is an import boom. Foreign producers would attempt to sell as much as possible in the US and other dollar-using economies. Over time, those cheaper imports would outsell domestically produced goods leading to slowing economic growth and a commensurately easing dollar. But at present there are major hindrances to that historic, equalizing process. Two and a half years after pandemic mitigation policies were put in effect, adverse effects linger. From supply chain bottlenecks, to energy shortages, to China's ongoing Zero Covid policies, but mostly due to global inflation, the price signals that guide the flow of goods and services have been blunted. Relative price changes are more difficult for business managers and entrepreneurs to detect as the general price level rises, so getting products from one place to another has become subject to miscalculation, increased delays, and higher costs.

The strength of the dollar is attributable to both geopolitical tensions and the aggressive response of the Federal Reserve to the inflationary updraft which began in early 2021.

Indeed, capital flows to the US have increased. US dollars are extremely liquid and readily convertible into interest-bearing US government securities, securities on which interest rates are currently rising.

A more accurate account of the latter cause, however, contrasts the Fed's delayed policy reaction to rising prices as nevertheless superior to the slow (if indeed any) action taken by other central banks. The US central bank was characterizing the uptrend in prices "transitory" far longer than it should have, but began lifting rates in March 2022. With inflation in the UK (as measured by the UK CPI, headline year-over-year) surpassing 10 percent this summer, Bank of England head Andrew Bailey came under fire for raising rates slowly, at small increments, and with little urgency. Similarly, the European Central Bank's main policy rate, the Deposit Facility Rate (negative since 2014) was raised to 0 percent in July 2022, then to .75 percent in mid-September 2022. The Bank of Japan's Policy Rate (Balance) has for years been, and remains, fixed at -.10 percent.

Central Bank Policy Rates of US Federal Reserve, Bank of England, Bank of Japan, and European Central Bank (2018 – present)



(Source: Bloomberg Finance, LP)

So in addition to the perception of the dollar as a safe asset, the reluctance of major central banks to combat inflation aggressively is driving the dollar up in value. Another, likely lesser, source of demand is pariah states. Having seen the effects of Russia's being pushed out of certain dollar-based payment

systems, it is likely that some stockpiling of dollars has taken place.

There is a rub to all of this, though. Complaints from other nations have been growing. These may lead to protectionism, currency interventions, or both. In September the Japanese government undertook a \$19.7 billion defense of the yen. Domestically, the mightiness of the US dollar, a direct effect of Fed policies, may undermine them. More affordable imports may spill over into domestic goods and services which, alongside lower (while still elevated) gasoline prices, may feed demand at a time when the Fed is actively working to diminish it.

US Dollar Index vs. EURUSD, GBPUSD, JPYUSD, AUDUSD, CADUSD (2021 – present)



(Source: Bloomberg Finance, LP)

All this raises a question for the near-term reign of King Dollar. Will foreign governments, the US Treasury, the Federal Reserve itself, or a coordinated effort between all of them, snatch away his crown?

At present it seems unlikely. Beyond jawboning, the Fed has demonstrated its commitment to fighting inflation. The series of 75 basis point "jumbo" rate increases makes an effort to weaken the dollar in the near term improbable. When the last purposeful effort to weaken the dollar was undertaken in 1985 (the Plaza Accord), it was facilitated by declining interest rates and disinflation.

On the other hand, a look at the shift in market expectations regarding the future direction of interest rates between the Fed's first rate hike (on March 16,

2022) and last week is noteworthy. Setting aside the level of rates, in March, traders believed (yellow dotted line, below) that the Fed would raise rates for two years, but that by March 2025 rates would be back on the decline, lower than the highest level of the hiking cycle. The shape of the market-implied rate curve last week (green line) tells a different story: Market participants now believe that Fed policy rates will reach their high in just six months (April 2023) before being lowered again.

Market Implied Policy Rates, 3 mo – 3 year



(Source: Bloomberg Finance, LP)

Whether Fed officials pivot away from their inflation fight or not, other central banks are far behind the curve. That is likely to keep the dollar at the top of the global currency pecking order. The growing intensification of the Russo-Ukrainian War is also likely to sustain the demand for dollar-denominated assets. With continuing dollar appreciation the likelihood of trade tensions and protectionism increase, as do the possibilities of organized labor agitation. King Dollar is secure for now, but as in all palaces, intrigues persist.

– October 12, 2022

The Private Disaster Response Alternative

ROBERT E. WRIGHT

Senior Research Faculty

Co-hosts of TV talk show “The View” recently mocked Florida’s Republican governor for asking for federal aid in the wake of the devastation Hurricane Ian. Mockingly they asked “Isn’t it socialism when the government helps you?”

Governments of *all* ideological stripes are supposed to help their citizens. The big policy questions are when, where, and how government is supposed to try to help and, when it does try, does it actually aid citizens or only further burden them.

But I can see why the co-hosts are confused. Socialism always fails, just like the US government does, including in the arena of emergency management. Remember the Katrina fiasco? The policies of the US Army Corps of Engineers made the storm’s effects worse than they had to be and FEMA’s response was belated and feeble. Recall former President Trump tossing rolls of paper towels in Puerto Rico, while many thousands remained without electricity a full year after Hurricane Maria wrecked the power grid of that island U.S. territory?

Such episodes raise serious doubts about the effectiveness of current disaster policies. Such policies’ cost inefficiency is even more troubling. Emergencies have become politicized due to incentives built into the 1988 Stafford Act, which committed the federal government to pay 75 to 100 percent of disaster costs with minimal cost oversight. Unsurprisingly, pressure to declare disasters has increased and costs have ballooned, stressing the nation’s Disaster Relief Fund. Every dollar unnecessarily spent or wasted on one disaster means a dollar not available to aid victims of the next natural calamity, less money available for other government programs, or higher taxes, including inflation.

I do not think that “global climate change” proponents have made their case, but *if* they prove correct and Americans are subject to more storms or more intense ones, then anyone who wants to “keep people safe” will have to support changing the nation’s disaster relief system if a more effective and efficient approach exists. And indeed one does.

That better approach relies on private initiative, markets, and insurance instead of ineffective government bureaucracies and bloated budgets. Literally every aspect of disaster relief can be privatized, or rather re-privatized, and should be, if policymakers want to save lives and money.

Ever wonder how people handled emergencies before the federal government began to “manage” them? Common sense, charity, and private insurance worked in concert.

Common sense means allowing prices to rise after disasters, so that private parties have incentives to stockpile necessities or to find innovative but relatively expensive ways to deliver them to areas made inaccessible by busted bridges, downed power lines, and the like. Competitive prices, given the circumstances, will prevail so long as artificial barriers to entry are battered down. It’s better to pay \$10 for a bottle of water than to have no potable water at all. FEMA’s “free” water isn’t free to taxpayers and it isn’t free to victims who perish from thirst or drinking contaminated water.

Common sense also entails not building flimsy but expensive permanent structures in areas subject to flooding, high winds, earthquakes, and such. Build it to last the blast or keep it cheap, so when the bayou bubbles all you lose is a wooden shack, one you can replace yourself, or with a little help from friends.

Formal private charity can also help hard-luck cases efficiently, carefully providing just enough resources to return the most needy to independence. Unlike government aid, which is expected to flow freely, especially to those who took big risks, private charity does not create a large moral hazard. Nobody builds a mansion on the edge of an active volcano expecting a bailout from the local church. But that church can easily aid the recent widow who cannot access her bank account due to widespread power outages.

The bulk of emergency aid and preventative services should come from private insurers, both life and property companies. They do not even need a government backstop, because they long ago learned how to spread their risks through reinsurance and retrocession (essentially insurance on reinsurance) contracts and alternative risk transfer markets. Over-regulation has made it difficult, though, to properly price risk. All else equal, people who build in places more likely to suffer from a natural disaster need to pay a higher premium than those who build in safer, but perhaps less scenic, spots.

If unfettered by regulators, for example, life insurers could inform insureds that a dangerous storm is on the way and if they do not evacuate their premium will increase, say, \$500.00, and suggest instead that the insureds spend the money driving to hotel upstate, or visiting relatives outside the danger zone. Wouldn't that work better than an unenforceable evacuation mandate?

Life, health, and property insurers would also have incentives to form disaster relief consortia to minimize post-disaster losses and claims. The consortia would act like private emergency agencies did in the nineteenth century, before insurance regulators got too heavy-handed. Banding together spreads costs and eliminates the need to check insurance cards before providing aid. Insurance consortia effectively and efficiently fought fires,

aided ships-in-distress, and helped farmers after their crops or herds met with disaster.

Even more importantly, risk insurers were able to reduce the chances of damage and death in the first place by providing insureds with economic incentives to take safety precautions, like employing fire-proofing technology or hiring only sober ship captains. They could not take on such roles again tomorrow, but over time, deregulation and these alternative provisions could reduce the federal backstop mandated by the Stafford Act by ten percentage points per year.

With the possible exception of some aspects of military defense and criminal justice, anything the government can do, the private sector can do better. Anything the government *can't* do, which is most things, the private sector *can* do, perhaps not perfectly, but well enough. That includes disaster relief.

– October 3, 2022

Fake Science Fuels Climate Extremism

DAVID BARKER

Contributor

“Follow the science,” we are told, especially the junk science that climate alarmists invent. I recently debunked a piece of junk climate science whose alarmism was featured in the *Wall Street Journal*, Bloomberg, CNN, CBS, and elsewhere. The junk science was produced by the Federal Reserve. Fed officials claimed that warming will cut economic growth by a third, but my simple statistical analysis showed their results were within the margin of error and that minor improvements and new data flip their result!

Mainstream economics shows that warming will have minor economic effects compared to the economic growth we expect over the next century. That is a problem for the climate lobby, which unfortunately includes the Fed. Since economic growth will swamp the economic effects of global warming, the Fed set out, it seems, to prove that warming will reduce growth. The fact that Florida, on average 26 degrees warmer than Michigan, has grown faster didn't faze them.

The Fed isn't the only institution to fall into chicanery. The study was published in a peer-reviewed academic economics journal, given wide media coverage, and cited in a congressional report to justify the Green New Deal. Bogus research makes big splashes. But when it is debunked, there isn't a ripple.

The best economic model, validated by a Nobel Prize for William Nordhaus, shows that if nothing is done to reduce emissions, warming will reduce world GDP by about three percent by the year 2100. If global GDP continues to grow at the rate it has been growing, then the world in 2100 will be five times richer than it is today. A three-percent

reduction in GDP would make us 4.8 times richer instead of 5.0 times. Not exactly catastrophic! Mainstream economics doesn't deny climate change and accepts that some policies to mitigate it might pass a cost-benefit test. But it does not predict a climate apocalypse, even if we do nothing.

To support apocalyptic predictions, the Fed, it seems, went after growth. Their study looked at the relationship between seasonal temperatures and growth, state by state and year by year, from 1957-2012. Higher summer temperatures were statistically associated with lower growth, while higher fall temperatures were associated with higher growth, but the fall effect was smaller than the summer effect. There was no statistically significant association between growth and temperatures in the winter and spring, so they subtracted the summer effect from the fall effect and concluded that the overall effect of higher temperatures was to lower economic growth.

The problem is that even if two estimates are statistically significant individually, their sum is not necessarily significant. For example, if moving to Florida would increase one person's income by \$1,000, plus or minus \$100, but would lower his spouse's income by \$1,100 plus or minus \$100, it is reasonable to say that the move will almost certainly raise the husband's income and lower his wife's income, but it is not nearly as clear that their total income will be lower. Even though the wife's expected loss is higher than her husband's gain, the odds that their overall income will be higher are substantial.

In addition, I found that removing California from the sample switched the result to an increase in

overall growth from a temperature increase, though without statistical significance. Using different data that measured the same things, the sign of the effect also flipped, though again without statistical significance. A statistically insignificant result that changes sign when estimated with different samples is exactly what we should expect if no true relationship exists. My work was published in *Econ Journal Watch*, another peer-reviewed academic journal that specializes in critiques of articles published in other journals.

That the Fed engages in politically biased research should not surprise us. A recent study of Fed personnel shows that the institution is very lopsided, politically.

Following the habits of good science is a good idea, but following the dictates of people who call themselves scientists is not the same thing. Climate change might be real, but there are good reasons to reject calls for draconian policies that fail cost-benefit tests.

– October 25, 2022

Pandemics and Liberty: An Introduction

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RYAN M. YONK (Senior Research Faculty)

The following is the introduction from the new AIER edited volume, *Pandemics & Liberty*.

“The single biggest threat to man’s continued dominance on the planet is the virus.”

~John Lederberg, Nobel Laureate in Medicine, 1958

“‘Emergencies’ have always been the pretext on which the safeguards of individual liberty have been eroded.”

~F.A. Hayek, Nobel Laureate in Economics, 1973

On February 9th, 2022, infectious disease expert and member of the President’s COVID-19 Response Team, Dr. Anthony Fauci announced that the US should begin “inching back to normalcy” (Steenhuysen, 2022). While admitting there is no perfect answer to when the country should begin to roll back restrictions enacted during the COVID-19 pandemic, Dr. Fauci elaborated, “The fact that the world and the United States and particularly certain parts of the United States are just up to here with COVID – they just really need to somehow get their life back” (Steenhuysen, 2022).

Dr. Fauci’s call came over two years after the first confirmed COVID-19 infection in the US (Holshue et al, 2020). Shortly after the first confirmed infection, outbreaks occurred first in the Seattle-Tacoma area and later in New York City. Fearing the worst, political figures at the state and federal level began urging for unprecedented restrictions on personal liberty to stop COVID-19 from spreading. A shortlist of these mandates includes stay-at-home measures, travel bans, closure of “nonessential” businesses (as

determined by governments), school and university closures, and wearing face-covering masks in public spaces.

Initial calls for these and other COVID-related mandates were intended for a short period and part of an effort to prevent hospitals from becoming overwhelmed with infected patients. Original plans asking citizens for “two weeks to flatten the curve” became multi-year operations as policy targets changed (Allen, 2020). In the process, students lost human capital, the US economy experienced its sharpest decline since the Great Depression, and countless medical procedures were delayed (Atlas, 2020). Further, three covid variants, over 1 million deaths, and countless other hardships later, many remain unsure if they will ever “get their life back.”¹ It’s also unclear what measures and government powers granted during the pandemic will persist after COVID (March, 2022).

Widespread hardships caused by COVID-19 and its responses generate many important but complex questions. What measures and actions taken did help slow or stop the spread of the virus? How much was governmental influence necessary? How much governmental impact was harmful or ineffective? Were lockdowns necessary? Did masks help prevent disease spread? Why did some states (and countries) fare better in addressing the pandemic than others?

Questions about the US response to COVID-19 also invite broader inquiry into the role of public policy during pandemics. What should be the goal of public policy during pandemics? Prevent overwhelming hospitals? Minimizing cases? Minimizing death? What roles should the government and markets play in these policies? How much should

the government be involved and what specifically should it do? Can individuals and citizens effectively organize and prevent the spread of disease? These are all trade-off questions that policymakers and public discourse often ignore (Boettke and Powell, 2022).

Unfortunately, analysis and policy debate is often overshadowed and politicized during public health emergencies. Costs vs. benefits of policy recommendations become left vs. right talking points. This edited volume hopes to provide something different: a careful assessment of the role of policy and liberty during pandemics based on theory, history, and policy analysis. Each chapter contributes to our understanding of this vital relationship in one of these aspects.

Our first set of chapters examines the theory and history of how societies have and can address pandemics. In Chapter 1, “Government Failure vs. The Market Process During the COVID-19 Pandemic,” Powell challenges the conventional understanding of the externality argument made during the COVID-19 pandemic. In Chapter 2, “Liberal Democracy, Economic Freedom and Pandemics,” Geloso argues that while liberal democracies may be constrained to combat pandemics, this limitation must be placed in context with their ability to create wealth and address other public health concerns. In Chapter 3, “A Panoramic ‘Systems’ Approach to the COVID-19 Pandemic,” Roy and Minassians review mental models’ role in shaping pandemic response.

Our second set of chapters reviews governments’ historical and contemporary track records during pandemics. In Chapter 4, “Pandemic Central Planning,” Magness outlines historical and contemporary failures of government actions taken to mitigate public health crises. In Chapter 5, “Pandemic Socialism: Hayek’s Critique of Scientism and the Fatal Conceit of Government Lockdowns,” Kibbe

and Waugh analyze the role of experts during the COVID-19 pandemic through a Hayekian lens. In Chapter 6, “Silence is Golden—Or is It? Presidential Communication During Pandemics,” Harrigan and Harrigan analyze how US Presidents have addressed pandemics historically by contrasting the presidencies of Woodrow Wilson and Donald Trump.

Our final set of chapters analyzes separate aspects of public policies undertaken during pandemics and provides implications for improving them for the next health crisis. In Chapter 7, “Public Health For Sale! Privately Improving Welfare and Public Health,” Carson examines several case studies where private actors provided effective public health efforts to combat malaria, HIV, and Ebola. In Chapter 8, “Polycentricity and COVID-19 Vaccination,” Herzberg argues for a polycentric approach to distributing the COVID-19 vaccine. In Chapter 9, “A Government Role Conducive to Liberty: Operation Warp Speed,” Escalante and Earle review the role of Operation Warp Speed in developing and distributing COVID-19 vaccines and make a case for when public interest and private enterprise can have meaningful collaboration. In Chapter 10, “One Size Fits All? Evaluating the Appropriateness of Monocentric Policies in COVID-19 Response,” Yonk and Janaskie explore how one-size-fits-all policy responses fail to account for real differences between local communities and suggest better alternatives based on polycentric approaches. In Chapter 11, “Desperate Times Call for Deregulation: How Less Oversight and More Markets Helped the US Battle the COVID-19 Pandemic,” March reviews the role of deregulation played in developing and providing COVID-19 treatment and tests within the US. In Chapter 12, “Rational Basis Review: The Irrational Obstacle to Challenging State and Local COVID-19 Mandates in Court,” Younes examines the legal environment and how courts have responded to COVID-19 Mandates. In Chapter 13, “After the

Pandemic: The Long-Run Impact of Pandemics on Liberty,” Goodman examines the long-term effects of policies enacted to mitigate disease spread.

The COVID-19 pandemic will end. But there will be more pandemics, and how (and how well) we can address them strongly depends on learning from contemporary and historical successes and failures. This volume aspires to take a step in this direction.

– October 5, 2022

Industrial Policy on Parade

VERONIQUE DE RUGY

Contributor

Reprinted from *EconLib*

It's no longer news that industrial policy is making a comeback. Too bad, that. In the zombie parade of bad policies that the left and the new right are now staging, this one is particularly baffling. Industrial policy has been tried on large scales – think the Soviet Union – and on smaller scales, including in the US and many other countries.

The fact that past industrial policy attempts were abandoned due to grotesque failure to achieve their goals seems to make no difference to those who are intent on reviving this practice. Indeed, we need not look as far back as the 1980s for evidence of the folly of trusting government to guide industrial development; we have a contemporary example. And this example is detailed by none other than the *New York Times*, which recently reported that, after years and billions of dollars, California's effort to build a high-speed train has been a disaster. A tidbit:

Now, as the nation embarks on a historic, \$1 trillion infrastructure building spree, the tortured effort to build the country's first high-speed rail system is a case study in how ambitious public works projects can become perilously encumbered by political compromise, unrealistic cost estimates, flawed engineering and a determination to persist on projects that have become, like the crippled financial institutions of 2008, too big to fail.

This effort qualifies as industrial policy because the government claims to know better than private markets what is the best means of transportation and

worth high-jacking resources to produce bureaucrats' preferred outcome. But as usual, government officials – spending other people's money – miss the obvious.

There's a reason why trains in the U.S. trains are far less popular than planes. There's a reason why travel by rail make more sense in small countries, and along the densely populated northeastern coast of the U.S. But politicians and intellectuals, enamored of the notion that trains are more friendly to the planet than are planes, ignore these realities in pushing for an industrial outcome that will likely never be profitable. For a walk down failed-rail-project memory lane see this piece by Phil Klein.

Building a high-speed rail connecting Los Angeles and San Francisco was always going to be challenging due to California's geography. And of course, most of you will not be surprised to learn that this large-scale government project is in fact failing, in large part because of the perverse incentives that pervade such a government project. From conception to planning to building, the incentives consistently encourage waste and error. Again, legislators aren't funding this boondoggle with their own money. Nor will they be personally accountable for cost overruns, failure to deliver, or what are certain to be many technical problems.

The cost overruns here are almost comical for something that literally hasn't been built yet. In 2008, the train's cost was projected to be \$33 billion. Fourteen years later the final plan is projected to cost \$113 billion – a mere 242 percent more than the sum used to peddle the scheme to the general public.

In addition, decisions on construction are unduly – but not unsurprisingly – influenced by special

interests rather than by good economic sense. As the *Times* writes: “political deals created serious obstacles in the project from the beginning.” Here’s more:

A review of hundreds of pages of documents, engineering reports, meeting transcripts and interviews with dozens of key political leaders show that the detour through the Mojave Desert was part of a string of decisions that, in hindsight, have seriously impeded the state’s ability to deliver on its promise to create a new way of transporting people in an era of climate change.

As if the project wasn’t difficult enough to deliver on, legislators decided to create costly detours to serve political friends:

Political compromises, the records show, produced difficult and costly routes through the state’s farm belt. They routed the train across a geologically complex mountain pass in the Bay Area. And they dictated that construction would begin in the center of the state, in the agricultural heartland, not at either of the urban ends where tens of millions of potential riders live....

Mike Antonovich, a powerful member of the Los Angeles County Board of Supervisors, was among those who argued that the train could get more riders if it diverted through the growing desert communities of Lancaster and Palmdale in his district, north of Los Angeles.

Even the SNCF engineers from France who came to work on the project eventually gave up:

There were so many things that went wrong,” Mr. McNamara said. “SNCF was very angry. They told the state they were leaving for North Africa, which was less politically dysfunctional. They went to Morocco and helped them build a rail system.

Morocco’s bullet train has been in service since 2018.

The report is worth reading in its entirety. It is the most ridiculous and clichéd story of why industrial policy fails. Such projects are often taken over by special interest groups (remember Alaska’s bridge to nowhere) that bloat the cost, and in extreme cases lead the project to failure.

This experience is commonplace. My colleague Jack Salmon told me about the plans for HS2, a high-speed rail project in the U.K., that started in 2009 to link London to Birmingham, Manchester, and Leeds. The high-speed train was promised to reduce the time of the journey by 30 minutes. Salmon sent me the following information:

The first stage was predicted to be completed by 2020, and with a further connection to Scotland operating by 2030. In 2010, the new conservative-led coalition amended 50% of the planned route after rural conservative MPs made a fuss about noise pollution and property values. At the time, the cost was estimated at about £30 billion. In 2013, the cost of the project was revised up to £50 billion. In 2014, the cost was revised to £57 billion. By 2019, the Oakervee review estimated that the projected cost, in 2019 prices, had increased to £88 billion. Lord Berkley, deputy chair of the review, said that these estimates were very optimistic and could actually be as high as £170 billion. The route is now estimated to be completed by 2045, although this will likely be pushed back. By that time, this £30 billion gravy train could end up costing £1 trillion.

That’s the problem with industrial policy, and such gravy train projects. Politicians can’t help themselves and these projects are always hijacked by special interests.

– October 23, 2022

Inflated Hopes and Burst Bubbles

ALEXANDER WILLIAM SALTER

Senior Fellow, Sound Money Project

September's inflation numbers aren't good. Prices rose 8.2 percent year-over-year, down slightly from the last release, yet still painful. The biggest news is "core" inflation, which excludes volatile food and energy prices. Core inflation hit 6.6 percent year-over-year, the highest since 1982. High core inflation suggests price pressures are broad-based, rather than limited to a few supply-constrained areas of the economy.

What can we expect the Fed to do? Despite angry noises from the peanut gallery, the central bank will almost certainly continue to tighten. Inflation this high, lasting this long, creates a crisis of legitimacy for the Fed. Nobody knows precisely what "stable prices" means, but we can be sure inflation running three times as high as the Fed's target doesn't qualify.

Let's not confuse *tighter* policy with *tight* policy, however. Interest on reserves, which is the Fed's primary monetary policy instrument, is currently 3.15 percent. That's a nominal interest rate. To calculate the real interest rate, we need to subtract expected inflation. Core prices have grown 0.6 percent per month over the last two months, or 7.2 percent on an annualized basis. Using that as the market's inflation expectation for next year, the expected real interest rate on reserves is -4.05 percent. If inflation were only half as high over the next month as core inflation has been over the previous two months, which seems very optimistic, the real interest rate on reserves would be -0.45 percent, still negative.

Ideally, the Fed would ensure the real interest rate it pays on reserves matches what economists call the natural real interest rate. This is the rate justified by economic fundamentals, such as

productivity growth, population growth, and time preferences. Natural interest rates are unobservable, but economists have estimates. One recent measure of the short-run natural rate of interest, published by the Fed, is 0.36 percent. Using our projected core inflation rate of 7.2 percent, that would imply the Fed should raise its policy rate to 7.56 percent. Obviously, that is much higher than the Fed has projected.

We must be cautious when relying on interest rates to gauge the stance of monetary policy. That said, careful consideration suggests that monetary policy isn't all that tight at the moment.

The next few FOMC meetings will be critical. There's growing pressure on the Fed to change course, or at least slow its pace of tightening. International financial markets, especially in the European Union and the United Kingdom, are spooked. The fallout from the Russia-Ukraine conflict, as well as China's economic woes and continued "zero COVID" restrictions, also spell trouble for the global economic outlook. At home, financiers are starting to grumble, as it turns out investment and capital allocation can be difficult when interest rates are positive. Lastly, we'd be naive to overlook the potential for partisan considerations to affect monetary policy. All these combined mean Fed Chair Jerome Powell has some tricky months ahead.

The Fed's chief task is to restore its lost credibility. In retrospect, the switch to average inflation targeting was a mistake. It gave the Fed plausible deniability for noisier, less predictable policy. Markets recognized this and responded accordingly. Now the Fed is in an uncomfortable position: it may have to ruffle a great many feathers by reducing

aggregate demand before markets are persuaded it means business.

There is a slight glimmer of hope. Long-run inflation expectations have moderated recently and appear stationary. Both the 5-year and 10-year breakeven inflation rates are holding at about 2.3 percent. This isn't a perfect measure; the market for inflation-indexed treasuries is pretty thin and the Fed has been a major purchaser since at least January 2022, which can throw off the numbers. Nevertheless, we have some signs that those with "skin in the game" expect continued moderation of monetary conditions. Sometimes, less bad is all you can get.

– October 18, 2022

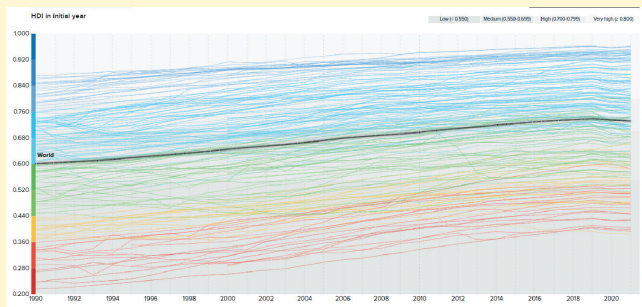
Concocting Crises

ROBERT E. WRIGHT

Senior Research Faculty

Due to the collapse of totalitarianism and the concomitant rise of economic freedom in the twentieth century, the rate of human progress became so rapid that paternalists and others bent on augmenting their own political power had to begin concocting crises to justify their preferred policy prescriptions.

Here is what the UN's Human Development Index looks like over the last three decades. Each line represents a country. While a few (Somalia, Syria, Venezuela, Zimbabwe, etc.) collapsed, many others saw steady-to-amazing gains, leading to a clear annual increase in the world average until 2020.



The mostly likely cause? Economic freedom. The percentage of countries rated as “free” by Freedom House increased from 25 in 1975 to 46 by the late 2000s, while the percent rated “not free” decreased from 41 to just 22 over that same span. (Those rated “partially free” hovered around 30 percent throughout.) Right on cue, though, the percentage rated “free” began to wane in 2020, while in that same year the percentage rated “not free” exceeded 28 percent for the first time since 1994.

Steady increases in freedom and human development was great news, right? Not for those who abhor classical liberalism and abjure limited government. The last three decades proved that there was literally

nothing for politicians and policymakers to do but to continue to relinquish power, or to find crises to exploit. Many chose the latter and became bearish on humanity.

I’m reminded of the description of those with short interests in securities traded on the Dutch stock market in the 17th century as described by Jose de la Vega in his aptly entitled 1688 tract *Confusion de Confusiones*:

The bears, on the contrary, are completely ruled by fear, trepidation, and nervousness. Rabbits become elephants, brawls in a tavern become rebellions, faint shadows appear to them as signs of chaos. But if there are sheep in Africa that are supposed to serve as donkeys and wethers to serve even as horses, what is there miraculous about the likelihood that every dwarf will become a giant in the eyes of the bears? . . .

In the telling of the bears, every bad thing that has happened in the last few decades portended doom. A handful of fanatics living in caves 10,000 miles away became an existential threat because they got lucky in an attack that could never be repeated. Another slightly closer fanatic was said to possess yellow cake uranium when he only had yellow toilets (made from gold). Every storm or drought became evidence for cataclysmic climate change.

In 2008, the bears said that the near failure of a few big banks threatened to obliterate the economy and everyone’s jobs along with it, although the sums paid to bail them out instead could have funded ample unemployment benefits for everyone put out of work by a downturn, and done so without creating massive moral hazard and hence sowing the seeds of future financial crises.

Not even a decade later, a POTUS with an unusual communication style spelled the end of “our democracy,” the bears growled. And when a new but hardly “novel” coronavirus began to spread

throughout the globe, bearish public health officials conflated case fatality rates with infection fatality rates, thus sowing panic and confusion that only they could alleviate.

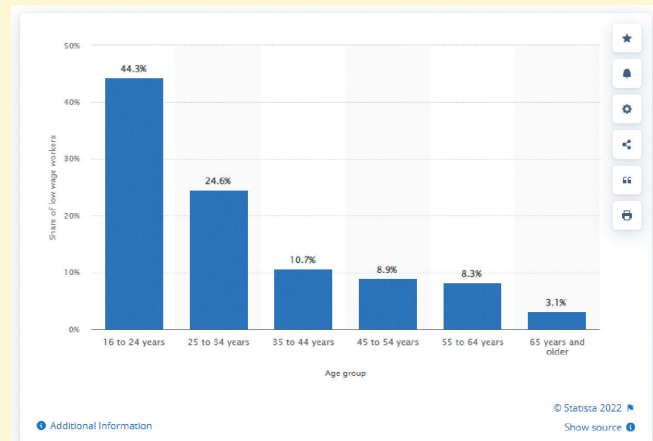
While all of that was going on, policy bears were also creating the illusion that income and wealth inequalities were soaring in America. Turns out, though, they weren't. AIER research director Phil Magness and coauthors have proven that widely cited data published by three scholarly permabears led by Tomas Piketty was wrong. Income inequality did not dip to low levels in the mid-twentieth century only to roar back in recent decades. In fact, income inequality *barely* changed at all over the last century.

But even if income inequality had followed Piketty's U-curve, average incomes have grown so strongly over the last century that it would not matter to anyone, presuming the situation was framed correctly. Would you rather make \$10,000 a year when your neighbor makes \$20,000, or would you rather make \$100,000 when your neighbor makes \$1,000,000?

Along with flawed income inequality statistics, policy bears have been pushing the notion of a crisis in socioeconomic mobility. The claim is that Americans born poor are likely to remain poor, while those born rich will most likely die rich. The campaign was effective as a 2019 study in PNAS showed that Americans overestimate the intergenerational persistence in income ranks. In other words, "they overestimate economic prospects for children from rich families and underestimate economic prospects for those from poor families."

Admittedly, anecdotal evidence based on informal polling of college students also suggests that most Americans support a higher federal minimum wage because they grossly overestimate the percentage and age of the workers who earn the minimum wage. Many think that minimum wage workers are older and trying to support families, when in fact about two-thirds are 34 years old or younger.

Percentage of Minimum Wage Hourly Workers in the U.S. in 2021 by Age



All told, minimum wage workers (which in government statistics include those who earn hourly wages and tips greater than the minimum wage) constitute less than 2 percent of the workforce paid an hourly wage. Similar data for states with minimum wage laws exceeding the federal level proved difficult to find. They are undoubtedly higher but nowhere near the level many Americans assume given frequent dire accounts of the "American Dream in crisis."

Of course none of this is to argue that the country or world is perfect and we should all sleep easy. But the most dire crisis of all may very well be the ability of those seeking to usurp power to create the appearance of crisis from mere bat viruses, lucky strikes, and statistical shadows.

– October 19, 2022

The CBDC Tradeoff

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The Biden administration recently released its Policy Objectives for a U.S. Central Bank Digital Currency (CBDC) System. The objectives follow up on an earlier executive order. The President has not yet committed to launching a CBDC, but the Treasury Department has recommended proceeding, and authorized “an interagency working group to consider the potential implications of a U.S. CBDC, leverage cross-government technical expertise, and share information with partners” led by, you guessed it, the Treasury Department. The decision to put Treasury officials in charge of the CBDC working group (rather than, say, central bankers) suggests the U.S. can expect a CBDC sooner or later. Federal Reserve officials have been somewhat lukewarm on the idea.

What is a Central Bank Digital Currency (CBDC)?

A CBDC is a digital dollar issued by the Federal Reserve that individuals can use to make payments.

When considering CBDCs, it’s important to recognize the difference between actual dollars and claims to actual dollars. Americans already have access to a host of digital-dollar accounts, which are provided by private banks and other financial institutions. But the assets in these accounts are not *actual* dollars. They are *claims* to actual dollars. Actual dollars consist only of physical cash and reserve balances held by banks at the Fed. Actual dollars are issued exclusively by the Fed and, since 1971, are not claims to some underlying asset. That one typically treats the balance in her checking account as being equivalent to the corresponding amount in cash reflects the

safety and soundness of the U.S. banking system. Nonetheless, a claim to actual dollars is distinct from actual dollars.

The Federal Reserve already issues digital dollars—actual dollars, not mere claims—in the form of reserve balances. These balances, however, are limited to financial institutions. Retail users cannot hold or spend reserve balances. A genuine Fed-issued CBDC would be very different in that respect. It would essentially allow Americans to open up an account at the Fed.

Competing Goals of a CBDC

The objectives offered by the administration are generally desirable in their own right, but some of the stated goals conflict with others in the context of issuing a CBDC.

Consider just two of the objectives offered. The administration wants a CBDC to improve payment systems (objective 3) and promote economic growth (objective 2). Both objectives are good things. And, at first glance, they appear to be reinforcing. A better payment system will make some transactions cheaper. As Adam Smith taught us long ago, the division of labor is limited by the extent of the market. A better payment system enables more exchange, and more exchange enables more production. Alas, a closer look at the relevant alternatives casts doubt on this rather rosy view.

It should go without saying that the benefits of improved payments will only be realized to the extent that people actually use the CBDC. It is not enough for the CBDC to offer cheap, instantaneous clearing. If no one uses it, then no benefits from the cheap, instantaneous clearing.

Here's the problem: the more people who use the CBDC, the less people will use traditional payment mechanisms. You might be scratching your head. Isn't this a good thing? Don't we want people using more efficient payment mechanisms? Yes! But we probably don't want them using more efficient payment mechanisms *provided by the government*.

Most people who choose to use a CBDC would have used some other payment mechanism provided by the private financial system, if a CBDC were not available. If people are holding more money in government-issued CBDC accounts, they are holding less money in private financial accounts. That's a big deal. Private financial institutions use deposits to support their lending activities. The conventional view is that financial depth (that is, more people with more funds in the private financial system) promotes economic growth. The logic is straightforward: more deposits means more financial intermediation, and more financial intermediation means entrepreneurs can take on more productive ventures.

A CBDC risks disintermediating the private financial system. Unless one thinks that the government will channel loanable funds into valuable investment projects at least as well as the private financial system, the shift of funds from private financial accounts to government-issued CBDC accounts will result in less productive investment and, hence, lower economic growth.

The risk that CBDCs may disintermediate the private financial system is well known. Consider a recent paper by Jonas Gross and Jonathan Schiller. Gross and Schiller acknowledge "that CBDCs crowd out bank deposits." "However," they write, "this crowding out effect can be mitigated if the central bank chooses to provide additional central bank funds or disincentivize large-scale CBDC accumulation through low CBDC interest rates." In other words, the government can limit disintermediation by discouraging people from using the CBDC.

Therein lies the tradeoff. To realize the improved-payment-system benefits of a CBDC, you need a lot of CBDC users. But a lot of CBDC users results in a lot of disintermediation. The government can mitigate disintermediation by discouraging so much CBDC use, but doing so also limits the improved-payment-system benefits of a CBDC.

A Better Way

It would be great if we could have fast, reliable payments that also enable the private financial system to continue providing valuable financial intermediation. And we can! The government didn't discover the payment system improvements. Those innovations were developed in the private sector. Rather than crowding out the private sector with a CBDC, the government should let a thousand payment mechanisms bloom.

– October 9, 2022

We Have Lifeboat Minds, But We Live in a Walmart World

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Economists generally assume that “people are rational” in any analytical discussion of preferences and behavior. But it sometimes seems that political “preferences” are not rational, because the effects of policies are the opposite of the stated intention. Some examples:

- Rent control is sold to the public as an antipoverty program, but it clearly harms poor people and makes it harder for them to find housing.
- Anti-gouging laws are supposed to make it possible for everyone to have access to essential supplies in an emergency, but their actual effect is to cause shortages, empty shelves, and long delays in the availability of new shipments of what people need.
- Restrictions on imports of raw material and manufactured products from other countries are supposed to “create jobs” domestically, but their actual effect is to raise the cost of intermediate goods and consumer products so much that the net effect is negative, as consumers pay more than workers receive.
- Minimum wages, occupational licensing, and other regulation of labor markets is supposed to benefit workers, but the actual effect is to reduce total employment and make it difficult for economically marginal folks to acquire the experience they would need to hold a full-time job at a good salary.

Public opinion on these questions indicates that the voting public varies from majority support for trade barriers and rent control to large majorities favoring anti-gouging laws and minimum wages.

The typical economist’s response seems to be that people are irrational, or “they just don’t understand.” I think we have atavistic Lifeboat minds, even though we now live in a Walmart world.

Rationally Irrational

An alternate view, argued by Brennan and Lomasky in their 1993 book *Democracy in Decision*, is that asking people what they want to vote for is not the same thing as asking people “*what policy would you implement if you were king?*” A rational person, after all, recognizes that they have no influence on the outcome of a vote, and casting a vote in favor of what “feels right” is rational, because it is costless to the individual. So I might prefer outcome A, but vote for outcome B because it makes me feel good to feel solidarity with a group that makes arguments about the public good, even if I know those arguments are specious.

Bryan Caplan’s 2008 *The Myth of the Rational Voter* goes a step further, pointing out that this free rider/collective action problem extends beyond voting behavior to actual beliefs. Voters are not just *rationally ignorant*, but are actually *rationally irrational*. The cause-and-effect relations between policy and outcomes become the subject of what amounts to faith, or a belief in magic, rather than being based on what can be shown to be true.

Atavism: The Lifeboat Mind

At play here is an older, and in some ways more fundamental, claim about human choices and behavior. Friedrich Hayek argued that there are mental architectures, which take the form of moral intuitions and heuristics, which are part of the evolved heritage of

the human species. As I have explained before, these are atavisms, an important concept in evolutionary biology. (Along these lines, see Klein, “The People’s Romance”)

In *The Fatal Conceit*, Hayek argued:

Mankind achieved civilization by developing and learning to follow rules (first in territorial tribes and then over broader reaches) that often forbade him to do what his instincts demanded, and no longer depended on a common perception of events. These rules, in effect constituting a new and different morality, and to which I would indeed prefer to confine the term ‘morality’, suppress or restrain the ‘natural morality’, i.e., those instincts that welded together the small group and secured cooperation within it at the cost of hindering or blocking its expansion.

In *Law, Legislation, and Liberty* Hayek expanded on this theme:

It should be realized, however, that the ideals of socialism (or of ‘social justice’) which ... prove so attractive, do not really offer a new moral but merely appeal to instincts inherited from an earlier type of society. *They are an atavism, a vain attempt to impose upon the Open Society the morals of the tribal society* which, if it prevails, must not only destroy the Great Society but would also greatly threaten the survival of the large numbers to which some three hundred years of a market order have enabled mankind to grow. (V. 3, p. 304; emphasis here and below added)

At present...an ever increasing part of the population of the Western World grow up as members of large organizations and thus as

strangers to those rules of the market which have made the great open society possible. *To them the market economy is largely incomprehensible; they have never practised the rules on which it rests, and its results seem to them irrational and immoral.*

They often see in it merely an arbitrary structure maintained by some sinister power. In consequence, the long-submerged innate instincts have again surged to the top. *Their demand for a just distribution in which organized power is to be used to allocate to each what he deserves, is thus strictly an atavism, based on primordial emotions.* And it is these widely prevalent feelings to which prophets, moral philosophers and constructivists appeal by their plan for the deliberate creation of a new type of society.

A “lifeboat” is a common device that philosophers often use as a kind of model, a simplifying device. It might go something like this: “Bert and Connie are in a lifeboat, in the middle of the Pacific Ocean, with no hope of immediate rescue. Bert has money, but he is very thirsty and starting to become dehydrated. Connie has water. Is it legitimate for Connie to charge Bert a high price for some of Connie’s water—She has plenty, and the water is after all worth a lot to Bert, so Bert would pay—or is Connie obliged to give Bert some water, to share?” The answer, in the philosopher’s example, is that if Connie charges Bert a high price, she is simply taking advantage of his desperate need; no additional water will be delivered to the lifeboat because the “signal” of scarcity, transmitted by the high price, is ineffective in the lifeboat model.

But the lifeboat model is not a verisimilar model of a modern market economy, because more stuff, including water, can almost always be obtained for a higher price. In fact, the whole point of markets

is the freedom to respond to price signals, with a corresponding increase in supply. If prices go up, then (1) consumers buy less; (2) producers make more; and (3) entrepreneurs devise substitutes. An alternative model, where even small increases in price produce immediate and substantial increases in the quantity available, is Walmart. The chain store famously has an extremely efficient and low-cost supply chain, capable of responding very quickly to specific shortages.

And that's the problem: We have Lifeboat minds, but we live in a Walmart world. The apparent contradictions I listed above, where economists mostly agree but the public believes something else, are not irrational in any important sense. Our evolved, atavistic response is that we don't like the price mechanism, and we resent our dependence on a complex system operating in the background, without anyone being "in charge."

Many of us are willing to pay a substantial amount in foregone material welfare to be able to impose our anachronistic worldview, born of the "lifeboat" setting of hunter-gatherer clans, that we should just share. The advantage of many political initiatives that purport to "help people" is that they appeal to our Lifeboat minds.

Hayek did not think that the situation was hopeless, and it still isn't. The key is to revive a sense of excitement, a positive optimistic vision of the possible future. As Hayek put it:

We must make the building of a free society once more an intellectual adventure, a deed of courage. What we lack is a liberal Utopia, a programme which seems neither a mere defence of things as they are nor a diluted kind of socialism, but a truly liberal radicalism which ...does not confine itself to what appears today as politically possible...

Free trade or the freedom of opportunity are ideals which still may arouse the imaginations

of large numbers, but a mere "reasonable freedom of trade" or a mere "relaxation of controls" are neither intellectually respectable nor likely to inspire any enthusiasm...

Unless we can make the philosophic foundations of a free society once more a living intellectual issue, and its implementation a task which challenges the ingenuity and imagination of our liveliest minds, the prospects of freedom are indeed dark. *But if we can regain that belief in power of ideas which was the mark of liberalism at its best, the battle is not lost.*

– October 15, 2022

Rising Inflation Expectations Pose a New Threat to Fed Efforts

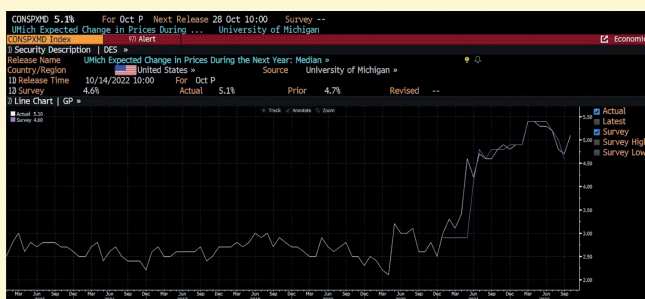
PETER C. EARLE

Research Faculty

Deep within Friday's University of Michigan (UMich) numbers was a worrisome sign for the Federal Reserve's inflation-fighting efforts. While the focus of the UMich releases tends to be on their consumer and current conditions surveys, another of their reports suggests an entrenching of inflation expectations both over one- and five-to-ten-year periods. The University of Michigan one-year inflation expectations (median) surged to 5.1 percent from 4.7 percent, the first increase since March 2022, when energy prices surged. For the five-to-ten-year survey, consumer inflation expectations rose from 2.7 percent to 2.9 percent.

It is likely that the recent upsurge in the average US price of a gallon of gasoline, from \$4.29 per gallon in mid-September to over \$4.50 more recently, accounts for at least some of those mounting expectations. Other areas in which month-to-month price increases were observed in September were food (up 0.8 percent), transportation services (up 1.9 percent), and shelter (up 0.7 percent).

University of Michigan, Expected Inflation in 1 year
(percent, median)



(Source: Bloomberg Finance, LP)

During inflationary periods, policymakers seek to ensure that expectations among consumers remain anchored. Consumer behaviors influence price setting by businesses. If individuals expect prices to rise substantially within the coming year, they are likely to purchase certain goods now, rather than wait. That behavior may stimulate increased production of the sought-after goods and, in turn, lead to higher prices. As former Federal Reserve Chair Paul Volcker said in 1979, "Inflation feeds in part on itself, so part of the job of returning to a more stable and more productive economy must be to break the grip of inflationary expectations."

To some extent, rising inflation expectations derive from the increased sensitivity of a population that has known stable prices for a substantial period of time. Between 1992 and the end of 2019, inflation (CPI, year-over-year) averaged 2.3 percent, albeit with some volatility during the 2008 financial crisis. That level of price fluctuations is a fraction of what prevailed over previous decades, wherein inflation averaged 5.6 percent throughout the 1980s and 7.1 percent through the 1970s.

Yet unanchored inflation expectations do not only indicate concern about future prices. They additionally suggest that the credibility of the monetary authority charged with fighting the increase in prices is not sufficient to warrant inaction. A growing number hold the view that despite Fed assurances, the resolve to fight inflation is less earnest than the instinct to rescue the economy from a severe recession, and that the so-called Fed Put remains in effect. Parties as diverse as Wharton Professor of Finance Jeremy Siegel and the United Nations have been increasing pressure to stop raising interest

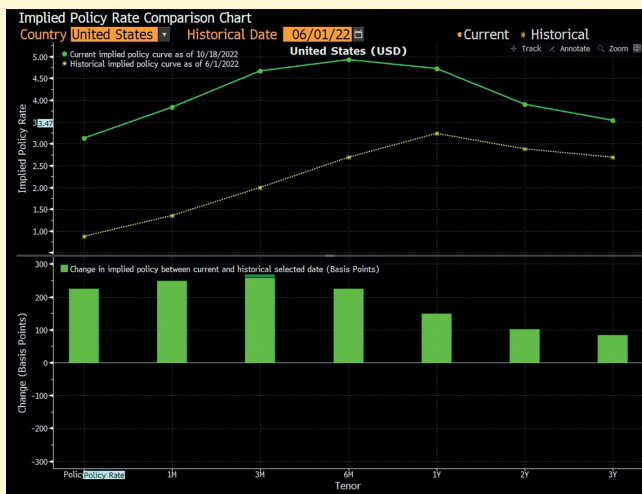
rates, despite the growth and persistence of inflation.

Indeed, as pointed out last week, market implied policy rates show expectations of a Fed policy reversal emerging. In fact, whereas in June 2022, market participants saw interest rates reaching a peak in one year (June 2023) before declining, presently markets see the rate peak in March 2023.

in anticipation of higher prices, a self-fulfilling prophecy may emerge. Herding, of sorts, may then thwart the effects of contractionary monetary policy measures to some degree. The Fed has a tough job ahead of it, one which may have just become a bit tougher.

– October 20, 2022

Market Implied Policy Rates, 18 October 2022 (green)
and 1 June 2022 (yellow)



(Source: Bloomberg Finance, LP)

The statement accompanying the UMich inflationary expectations report commented that “[i]nflation expectations are likely to remain relatively unstable in the months ahead, as consumer uncertainty over ... expectations remain[s] high and is unlikely to wane in the face of continued global pressures on inflation.” The recent OPEC decision to cut production, as well downward pressure on the wealth effect from declines in the stock market and housing prices, may be sufficient to continue driving inflation expectations higher.

Add to all of that the growing gulf between what consumers and investors see versus what political figures are saying, and uncertainty over the future path of prices is likely to increase. If those expectations lead to consumption patterns being adjusted

A Central Bank Reckoning

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Reprinted from *Law & Liberty*

Judging from reputable opinion-polling, distrust of public institutions is widespread throughout Western nations today. Whether it is legislatures, courts, or national security agencies, many people across the political spectrum believe that such institutions are prioritizing their own interests and those of the politically well-connected over and above the general welfare. In other instances, the anger reflects an awareness that some of these institutions have failed to fulfill their primary responsibilities.

Central banks across the West presently fall into the latter category. Alex Pollock's deft analysis of the Volcker Fed's war against inflation in the early 1980s reminds us that America, along with most other Western countries, finds itself confronting similar circumstances today. For Paul Volcker's drastic and ultimately successful measures to curb a major inflationary outbreak occurred against a background of serious monetary and economic policy mistakes in the late-1960s and early-1970s. The same script, Pollock illustrates, is playing out today, with the failure of central bankers to resist political pressures to do what they should not playing a major role in our present inflationary troubles.

No One Likes Admitting Failure

During America's last inflationary crisis, there were some mea culpas by a few central bankers. Pollock highlights former Federal Reserve Chair Arthur Burns' famous 1979 lecture, "The Anguish of Central Banking," in which he acknowledged that central bankers had failed to do their job. There seems far less willingness by their contemporary

successors to acknowledge similar failures on their part today.

It took some months before Fed Chair Jerome Powell decided that it was time to "retire" the narrative of "transitory inflation." Nota bene: Powell did not do so until after being reconfirmed as Fed Chair. It requires no stretch of the imagination to posit that Powell avoided stating that inflation was not in fact transitory because he knew this would have contradicted the White House's preferred inflationary story (supply-chain issues, etc.). That might have thrown Powell's renomination by President Joe Biden into doubt. The problem is that the rhetoric of transitory inflation was not the message that markets, businesses, and consumers needed to hear.

No doubt many central bankers do not believe that now is the time for engaging in retrospectives about where they made errors. Their focus, it could be argued, should be on reducing inflation and, equally importantly, getting inflationary expectations under control. Encouraging institutional self-doubt will not help the situation. Ergo, any such examination of conscience is surely better conducted after the inflationary crisis has been mastered.

Perhaps so. But if outfits like the Fed, the European Central Bank, and the Bank of England do get inflation under control, there is good reason to believe that many central bankers will want to avoid too much discussion about what went wrong.

Admitting mistakes is never something that policymakers are especially interested in doing, not least because it raises questions about who should be held accountable for errors. More generally, there are broader challenges facing central banks, many of which go beyond economics, that central bankers

may be reluctant to address. Two such interrelated problems concern, first, how central banks restore their credibility in the wake of failure, and, secondly, the meaning of central bank independence in the future.

Not So Independent

From the early-1990s onwards, central banks throughout Western countries started acquiring a reputation for being the adults in the room. As Pollock notes, Paul Volcker was able to state with confidence in 1990 that “central banks are in exceptionally good repute these days.” On one level, this owed something to the political dexterity of leading central bankers like the Fed’s Alan Greenspan and the Bundesbank’s Hans Tietmeyer. At the time, they were widely regarded as safe pairs of hands for monetary policy. This went together with the growth of widespread agreement across the world that central banks should acquire some insulation from political influence.

Insufficient insularity from political pressures had been one reason why central banks had made major mistakes in the late-60s and early-70s. President Richard Nixon’s successful strong-arming of Arthur Burns (subsequently confirmed by releases from the Nixon Tapes) to have the Fed engage in expansionary monetary policy in the run-up to the 1972 presidential election at a time when inflation was growing is one example to which scholars retrospectively pointed. Also driving the move towards central bank independence were empirical studies that began emerging in the 1970s that measured the relationship between such independence and inflation.

So it was that central banks like the Reserve Bank of Australia and the Bank of England acquired some degree of formal independence in the 1990s. More importantly, the European Central Bank established in 1999 was given a primary mandate to “maintain price stability” (as stated in Protocol No

4, Chapter 2, Article 2 of the consolidated Treaty of European Union). The ECB was also given considerable autonomy concerning what tools it could use to realize this. This represented a victory, or so it seemed, for Tietmeyer and the Bundesbank over French desires for an ECB with a wider brief that would enable it to, for example, actively stimulate employment markets.

Such relative independence has not, however, prevented central banks across the world from time and again being drawn into activities in ways that suggest that they are not as shielded from political machinations as many hoped they would be. Indeed, many central bankers plainly believe that they should embrace (or at least not contradict) the broader economic agenda being pursued by governments, even if that agenda distracts the central bank from its prime responsibilities. No state institution, the logic goes, can remain too out of step for too long with the government if it wants to maintain its autonomy over the long term.

Since the 2008 Financial Crisis, for example, the ECB has engaged in several bailouts of insolvent states and operated as a de facto transfer union. Its purported legal basis for these actions has been what is called the ECB’s “secondary mandate.” As stated in the Treaty of European Union, “Without prejudice to the objective of price stability, the ECB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union.”

One would think that the important caveat contained in this sentence’s first clause would have put major guardrails around the ECB’s ability to stray beyond its primary mandate. But it has not. This is despite Germany’s Federal Constitutional Court finding as recently as May 2020 that the German government had violated the Federal Republic’s Basic Law on account of its failure to rebuke the ECB for pursuing

what amounts to a quasi-fiscal policy.

That tendency of governments to say as little as possible about such ECB interventions (and never question their legality) has nothing to do with respecting the ECB's independence. Instead, it has everything to do with European governments wanting the ECB to engage in such activities, however constitutionally dubious they may be, and however much they may compromise realization of the ECB's primary objective. After all, these interventions permit governments of countries like Greece and Italy to avoid making the fiscally hard and politically unpopular decisions needed to restore sanity to their public expenditures. An ECB that took its independence and primary mandate seriously would presumably say: "No, we cannot intervene in the way that some governments may want because our authority to do so is at best unclear. Nor can we do anything that prejudices our ability to realize our primary mandate." But it has not.

A Question of Credibility

Presuming that Western countries eventually overcome their current inflationary woes, and that they don't find themselves mired in stagflation, a significant challenge for central banks will be how to restore their credibility as bulwarks against inflation. It won't be enough for them to brag about how they got inflation under control as it will be hard to deny that their errors—like the Fed's massively expansive monetary policy throughout 2020—helped, as Pollock shows, inflict "the present inflation upon us."

Some scholars have offered a range of options for addressing such issues going forward. Peter J. Boettke, Alexander William Salter, and Daniel J. Smith have argued that we need to wrap the conduct of monetary policy tightly in basic principles of rule of law, such as the predictability that flows from creating and enforcing rules in a non-arbitrary manner. This, they argue, would limit the scope for

central bankers to behave opportunistically and for politicians to encourage them to do so.

This and similar proposals should be given serious consideration. That said, even the best set of rules and the tightest, most targeted, narrowly circumscribed mandate won't be enough unless central bankers are willing to emulate something akin to judicial restraint. By this, I mean a principled refusal—one that takes on the form of a norm or convention—on central bankers' part to involve themselves in areas for which others bear prime decision-making responsibility.

By virtue of their monopoly of the money supply and the considerable discretion they exercise in setting monetary policy, central banks are incredibly powerful institutions. That power, combined with the ability of very smart people to find creative ways around the strictest laws (especially during crises), illustrates our need for central bankers willing to say and do what Arthur Burns did not say or do in 1971. A norm and convention that I'll call "central bank restraint" would help furnish a normative-legal foundation for them to do so.

Underpinning this norm and convention would be a commitment to the principle that central bankers' specific contribution to the general welfare is to maintain stability in the value of money, and that this means saying "no" to those anxious for central banks to wander away beyond that goal. Certainly, adherence to such a norm and convention would be partly a question of incentives as well as a wider grasp of why observing the underlying principle is important. But it is also a matter of intellectual conviction and moral character.

Put another way, we not only need to find ways of making it more probable that people like Paul Volcker become senior central bankers long before a crisis necessitates putting a Paul Volcker in charge. Central bankers also need principles and procedures accepted as true and correct to which they can point

as the lodestone and limits of their responsibilities.

Whether our political class has the requisite imagination and courage to entertain ideas like central bank restraint is a different question. I confess myself pessimistic that they have much capacity to do so.

– October 5, 2022



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