

RESEARCH REPORTS

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RESEARCH REPORTS

AIER publishes over 100 articles per month that are distributed in digital form. Research Reports contains Business Conditions Monthly plus 10 of the most representative, chosen here for popularity, variety, and relevance. These articles are often reprinted in venues around the web, including *Seeking Alpha*, *Intellectual Takeout*, *Mises Brasil*, and dozens of other outlets. To read all of them, go to

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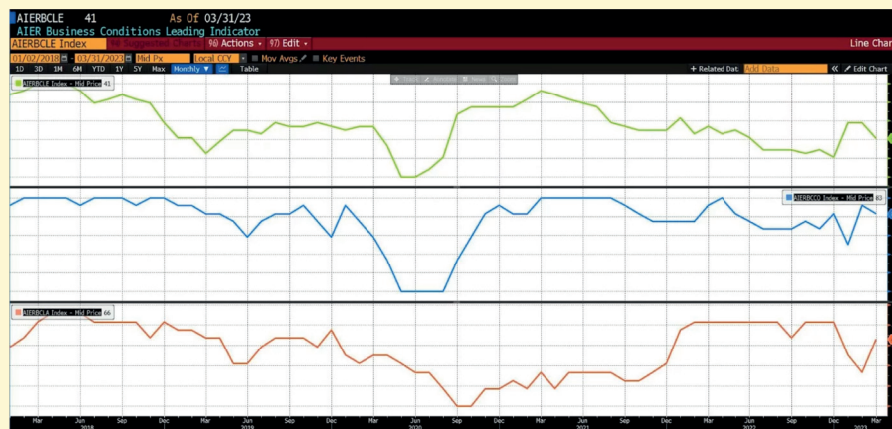
BUSINESS CONDITIONS MONTHLY

Peter C. Earle

RESEARCH FACULTY

A IER's Leading Indicator fell to 41 in March 2023 from 58 in February, ending a two month period of moderate expansion to fall back to the contractionary levels which dominated the second half of 2022. Our Roughly Coincident Indicator fell from 92 to 83 in March 2023, while the Lagging Indicator rose from a moderately contractionary reading of 33, to 66. The Roughly Coincident Indicator has been in an uptrend, at varying levels, since October 2020, broken only by a reading of 50 in January 2023. The Lagging Indicator, meanwhile, broke above a predominance of downtrending readings in January of 2022, declining from 83 in December 2022, to 50 in January 2023, 33 in February 2023, and 66 in March.

AIER Business Conditions Monthly [5 years]



Leading Indicators (41)

The Leading Indicators continued to generate mixed signals between February and March 2023. Two of the three Conference Board Indices rose in March: the Leading Index of Manufacturers New Orders for Consumer Goods and Materials (0.09 percent) and Manufacturers of New Orders for Nondefense Capital Goods ex. Aircraft (0.45 percent). Debit balances in brokerage margin accounts increased by just over 21,000 (3.4 percent), and the 1-to-10 year US Treasury spread widened by 5 basis points (5.3 percent).

The third of the three Conference Board Indices in our Leading Indicators Index, the Index of Stock Prices of 500 Common Stocks, declined by 2.7 percent. Also falling were the University of Michigan Consumer Expectations Index (-8.5 percent), New Privately Owned Housing Units Started by Structure (-0.8 percent), Adjusted Retail and Food Services Sales (-0.6 percent), and Heavy Truck Sales (-6.2 percent). Both the US Average Weekly Hours for All Employees Manufacturing and the Inventory/Sales Ratio (Total Business) were essentially unchanged. Unlike the February 2023 readings, ten of twelve constituent indices in our Leading Indicators Index showed significant changes in March 2023, whether positive or negative.

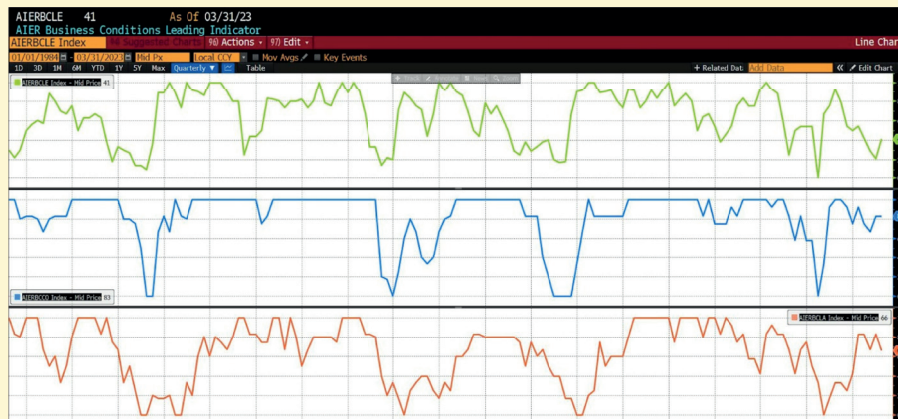
From approximately August 2021 through June 2022, our composite of twelve Leading Indicators maintained a mostly neutral level. Between July and December 2022, that bias shifted into a contractionary trend, which was broken by a shift to moderately expansionary reading in January and February 2023. The return to moderately contractionary readings is likely indicative of several noteworthy developments in March.

Roughly Coincident (83) and Lagging (66) Indicators

Five of the six indicators in the Coincident Index increased in March 2023. Two of three Conference Board Indices in this category, Manufacturing and Trade Sales and Personal Income Less Transfer Payments, grew by 0.2 percent each. The Conference Board's Consumer Confidence Present Situation fell by 1.2 percent. Also edging up in March 2023 were US Industrial Production (0.4 percent), US Employees on Nonfarm Payrolls (0.2 percent), and the US Labor Force Participation rate (0.2 percent). Five of these six monthly changes are barely outside the threshold of neutrality, again showing the “churn” in certain economic activity measures discussed last month.

Lagging Indicators varied as well in March, but showed more significant changes. The Conference Board's Lagging Average Duration of Unemployment rose by 1 percent as Lagging Commercial and Industrial Loans fell by 1.4 percent. The ISM Manufacturing Report on Business Inventories increased by 0.2 percent. The US Census Bureau's Index of Private Construction Spending (Nonresidential), the US Consumer Price Index ex. Food and Energy (year-over-year), and 30-day average yields rose 0.8 percent, 0.10 percent, and 8.1 percent, respectively.

AIER Business Conditions Monthly (1985 – present)



Concerns over decelerating disinflation in the first two months of the year were compounded in March 2023 by a number of high-profile bank failures. The result was tighter credit conditions, and questions regarding whether the Federal Reserve would continue its interest-rate-hiking campaign amid the revelation that US banks have hundreds of billions of dollars in unrealized losses on assets in held-to-maturity accounts. Indeed, despite the unique conditions surrounding the failures of Silicon Valley Bank, Signature Bank, and troubles at First Republic Bank, a constituency has grown urging the Fed to pause or even begin cutting interest rates again. The Federal Open Market Committee voted 11-0 to raise rates 25 basis points (a 4.75 to 5.00 percent Fed Funds target) at their 22 March 2023 meeting, while softening its language somewhat regarding future rate hikes. A presumably final 25 basis point hike is expected at the 2-3 May FOMC meeting.

There are increasing signs that the contractionary monetary policy measures that began in March 2022 are taking effect.

The Institute for Supply Management's gauge of manufacturing activity fell to its lowest levels since May 2020 in March 2023, which, excluding the COVID pandemic, is its lowest level since 2009. A surprise uptick in industrial production in March is questionable, owing to historic noisiness in the data. Regional economic data from Chicago, Dallas, and Philadelphia showed growing economic weakness as well.

Consumer confidence (as measured by the University of Michigan's Survey of Consumers) fell in March 2023 for the first time in four months among all demographics, although the drop was sharpest for younger, lower-income, and less-educated groups. While there are likely several reasons for this, foremost is that those groups are the most likely to have been adversely impacted by nearly two years of surging inflation, as well as the unanticipated degree of "stickiness" in service prices, including rents. Inflation expectations in March 2023 stood at 3.6 percent, down from just over 4 percent in February 2023, but still far above average expectations for the two years leading up to the COVID pandemic. Together, the downward trend in consumer confidence accompanied by elevated inflation expectations and higher debt service would be anticipated to impact consumer spending, and in March 2023 that was in evidence. Headline sales dropped 1 percent in March, with weakness visible across many categories: general merchandise, down 3 percent in March versus an 0.9 percent gain in February; discretionary goods (e.g. electronics) down 2.1 percent in March versus a 1.5-percent drop in February; and clothing down 1.7 percent versus a 2-percent decline the prior month. The Confidence Board reported that "consumers plan to spend less on highly discretionary categories such as playing the lottery, visiting amusement parks, going to the movies, personal lodging, and dining."

Amid a plethora of vacillating economic signals, only a handful of US employment measures (other than inflation) have been consistent over the last several quarters. In March 2023, however, some long-anticipated softness materialized in labor markets. In addition to unseasonably warm weather during the winter of 2022-2023 generating excess hiring (and longer-than-average seasonal retention), thus distorting the employment picture somewhat, tech and finance layoffs accelerated through March. Further, a decline in average weekly hours worked in March offset a wage increase of 0.3 percent in February 2023. And when considering total hours worked (versus number of workers), the decline in the amount of labor used in March 2023 corresponds roughly with 185,000 fewer full-time workers. According to ADP, private payrolls increased 145,000 in March 2023, versus an expected 200,000, and as compared to an increase of 261,000 in February 2023.

Persistent inflation, elevated inflation expectations, and credit tightness on top of the Fed's contractionary measures are causing trepidation among consumers. One expects that amid high prices and rising debt-service costs, consumers will be increasingly unlikely to tap into excess savings from the pandemic to finance consumption. More troubling is rapidly declining business optimism: in March, the National Federation of Independent Business reported that 25 percent of poll respondents identified ongoing inflation as their biggest problem, with fewer than half (47 percent) expecting better business conditions within the next six months. Delayed, curtailed, or canceled capital expenditure (capex) plans among large US companies similarly suggest dimming growth prospects.

A handful of other current economic and financial indications bear mentioning here.

1. Yield-curve inversions

Yield curve inversions are regularly cited as predictors of recessions. They are generally an unreliable method of predicting recessions for reasons (and corresponding to data) shown both in this article and this one. But if many financial market participants are watching them, there may be value in following them. Bloomberg tracks the probability of recessions associated with various yield curve inversions. Three, with their associated predictions of a recession within 12 months, are shown below over a twenty-year period.

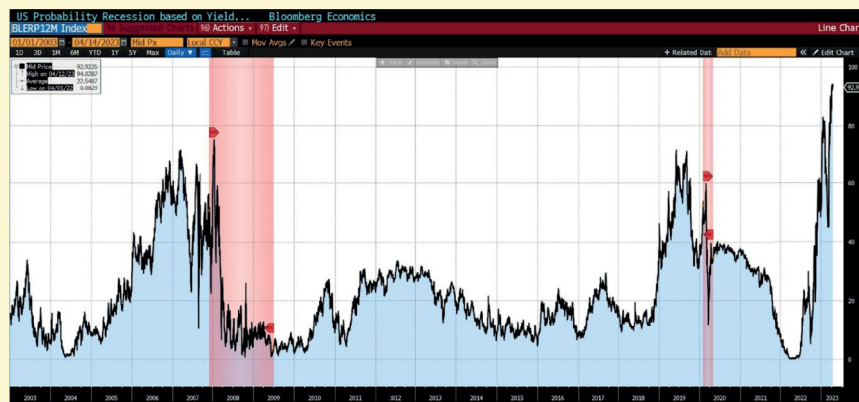
US Probability of Recession within 12 months based upon 3mo 10y YC inversion



US Probability of Recession within 12 months based upon 2yr 10y YC inversion



US Probability of Recession within 12 months based upon 3mo 18mo YC inversion



The probability of a recession within the next twelve months associated with each of these three yield curve inversions are, respectively:

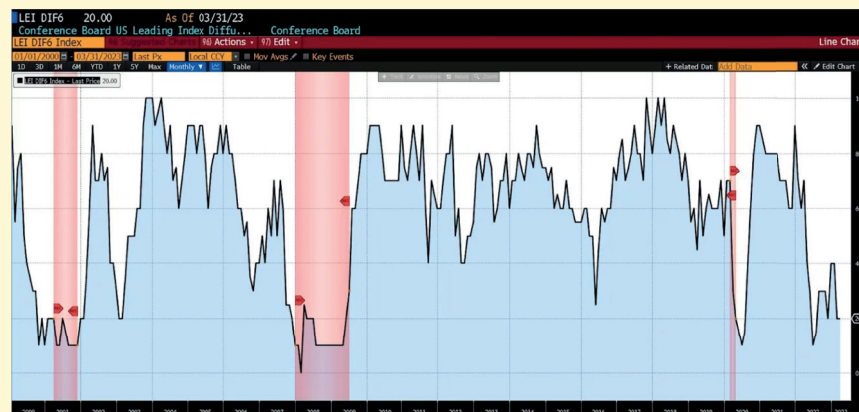
- 83 percent for the 3 mo-10yr;
- 62 percent for the 2 yr-10 yr;
- 93 percent for the 3 mo-18 mo.

But the varying lag times of each yield curve inversion associated with the subsequent two recessions since 2003 (and noting that the 2022 recession has not yet been blessed by the National Bureau of Economic Research) leave much to be desired as a predictive indicator. Additionally, in each of the spreads the inversions are presently much greater than those that seem to be associated with past recessions.

2. Leading Index of Employment Diffusion

Various diffusion indices are published by the Conference Board. The 6-month leading index of diffusion shows the breadth of job gains. Breadth of hiring tends to narrow significantly before recessions. The current 6-month employment diffusion is at levels frequently seen before recessions.

Conference Board US Leading Index Diffusion 6-Month Span (2000 – present)



3. The Present Situation vs. Expectation “Wedge” in Consumer Confidence

The spread between individuals’ assessment of the present economic situation and their expectations tends to travel in close tandem, but widens with rising uncertainty. That spread tends to widen before recessions, implying more caution in consumption. It is currently at its widest point since before the pandemic.

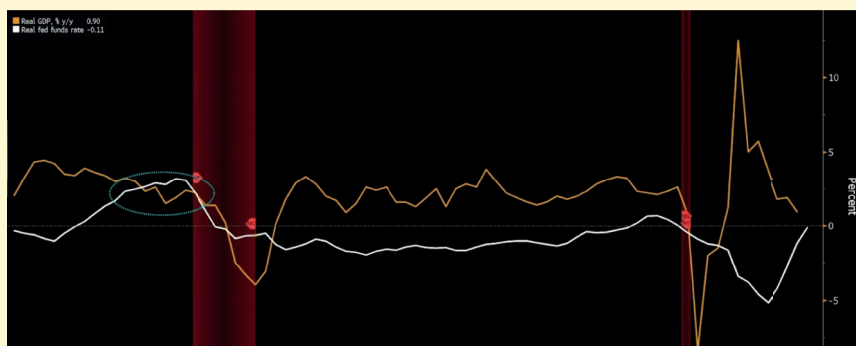
Present situation (orange) versus Expectations (blue) “wedge” (2000 – present)



4. Economic Growth versus Short-term Interest Rates

Frequently throughout history, when real short-term interest rates have exceeded GDP growth, a recession has followed. At present that is not the case, but with a weak recovery from the brief 2022 recession and short-term rates still climbing, this indicator is one we will be tracking.

Real Interest Rates versus Economic Growth (2003 – present)



5. The Earnings Recession

An “earnings recession” occurs when corporate earnings have declined or gone negative for at least two consecutive quarters. As reported in FactSet two days ago:

The (blended) net profit margin for the S&P 500 for Q1 2023 is 11.2 percent, which is below the previous quarter’s net profit margin, below the year-ago net profit margin, and below the 5-year average net profit margin (11.4%). If 11.2 percent is the actual net profit margin for the quarter, it will mark the

seventh straight quarter in which the net profit margin for the index has declined quarter-over-quarter. It will also mark the lowest net profit margin reported by the index since Q4 2020 (10.9 percent).

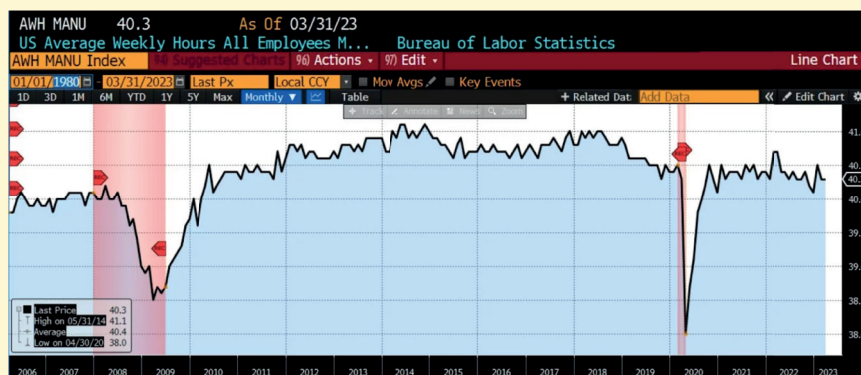
Earnings declines frequently precede recessions.

The bottom line: None of these indicators are conclusive, and all are subject to change or revision, but in the aggregate they serve to buttress an accumulation of economic evidence which prior to March 2023 was more conflicting.

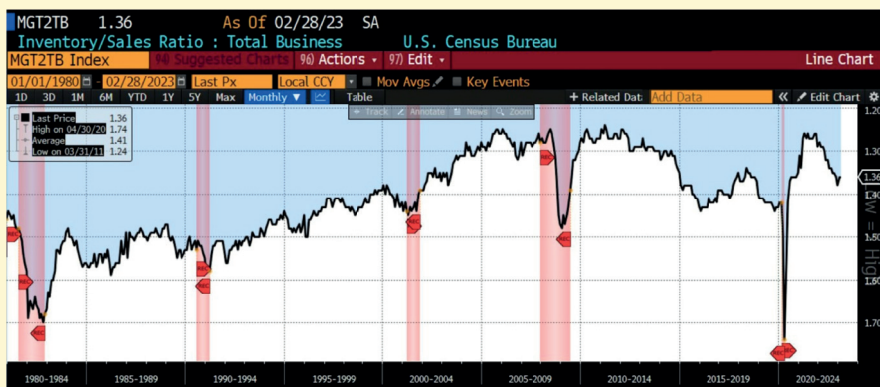
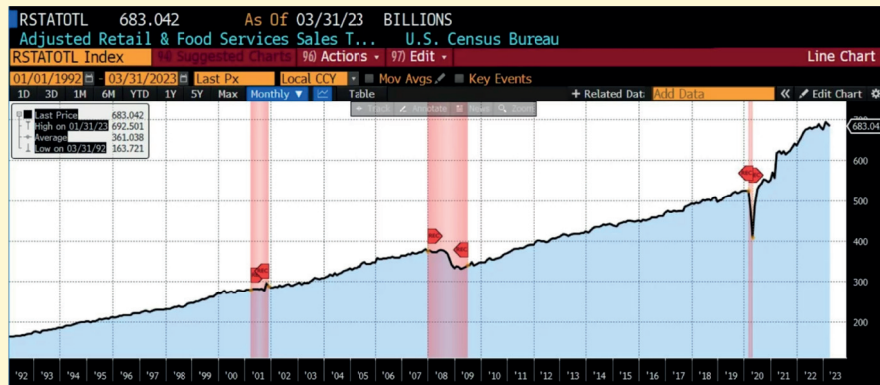
US economic fundamentals are now clearly deteriorating, with risks compounding to the downside. The current baseline estimate is for an economic recession within the next twelve to eighteen months.

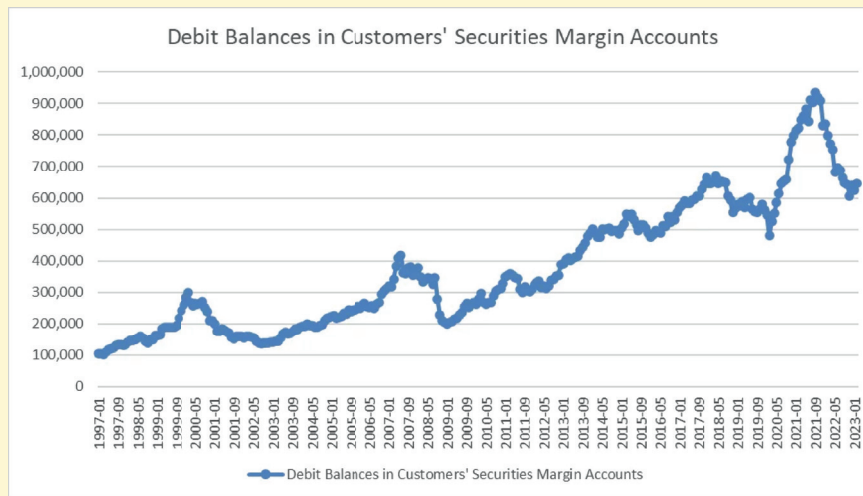
Errata: Beginning this month, where possible, charts have been sourced with white backgrounds to make reading easier. Recession start and end dates have been added.

LEADING INDICATORS (1980 – present where possible)

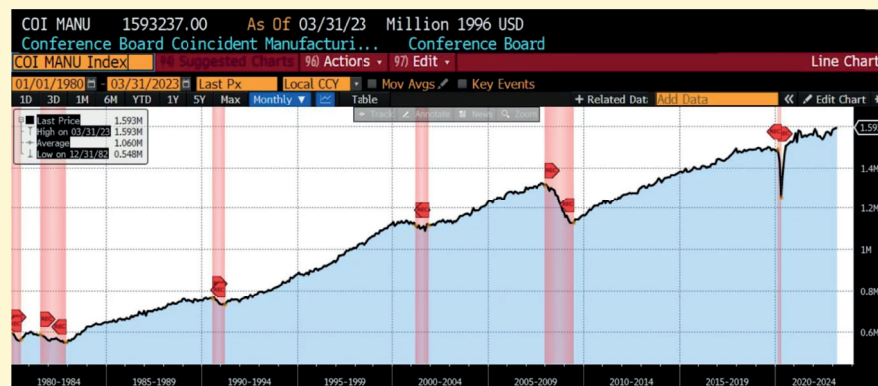


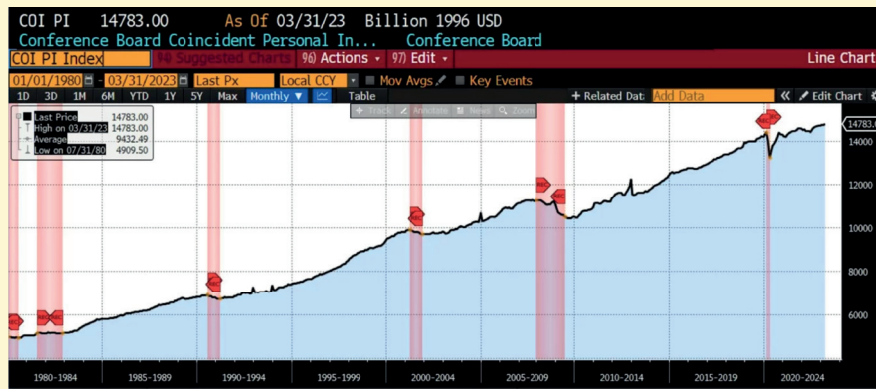


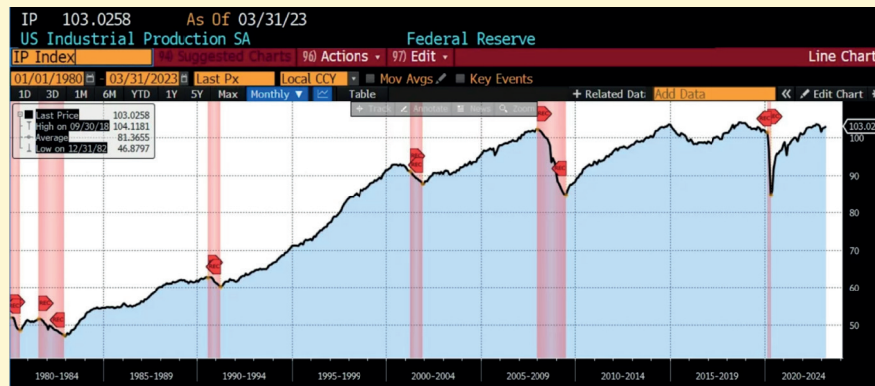




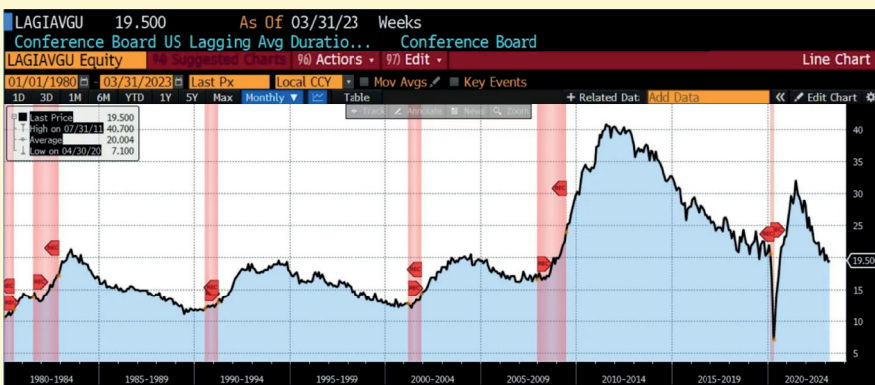
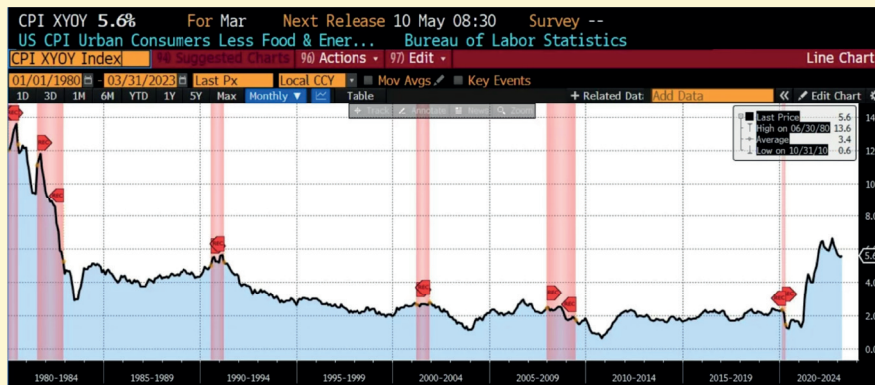
ROUGHLY COINCIDENT INDICATORS (1980 present where possible)

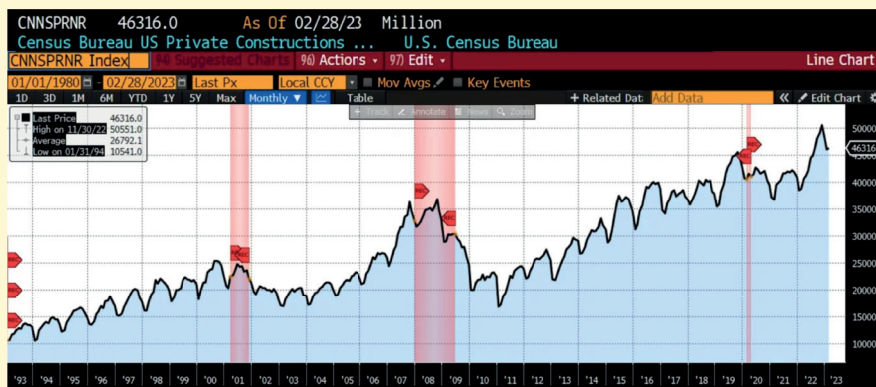
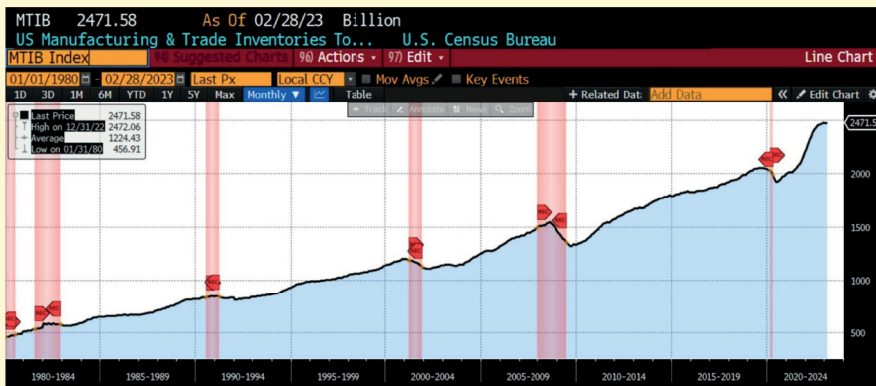






LAGGING INDICATORS (1980 present where possible)





CAPITAL MARKET PERFORMANCE

	Ticker	Short Name	%1M	%3M	%1YR	3 Year Annualized	5 Year Annualized	10 Year Annualized
	SPR	S&P 1500 Composite Index	+2.42%	-.34%	-2.63%	15.5097	10.9497	11.9810
	SPXT	d S&P 500 Total Return	+2.64%	+.71%	-.78%	15.2258	11.3787	12.2244
	SPX	d S&P 500 INDEX	+2.53%	+.28%	-2.48%	15.2041	11.3610	12.2086
	MID	d S&P 400 MIDCAP INDEX	+1.96%	-6.08%	-2.82%	18.9827	7.4428	9.7617
	RTY	d RUSSELL 2000 INDEX	+6.4%	-8.26%	-7.64%	14.5905	4.1960	8.0050
	SXRP	d STXE 600 (EUR) Pr	+6.13%	+2.89%	+5.89%	15.9951	7.5688	8.1461
	TLT US	d ISHARES 20+ YEAR	+1.0%	-.48%	-11.74%	-13.2599	-.1563	1.3647
	QLTA US	d ISHARES AAA - A	+.40%	-.32%	-3.32%	-3.2181	1.6026	1.8114
	CRY	d TR/CC CRB ER Index	+3.98%	-3.85%	-11.20%	34.2145	6.3775	-1.0106
	XAU	Gold Spot \$/Oz	+2.19%	+3.65%	+4.94%			
	XAG	Silver Spot \$/Oz	+8.57%	+4.79%	+6.71%			
	ILM3NAVG	Bankrate 30Y Mortgage Rates Na	+.59%	+6.53%	+29.49%			
	ILM1NAVG	Bankrate 15Y Mortgage Rates Na	+3.81%	+10.78%	+40.58%			
	MB301ARM	5 Year ARM	-2.28%	+4.71%	+35.94%			
	ILA3NAVG	Bankrate 30Y Fixe Mtg Refis Na	+3.11%	+6.09%	+71.67%			

(All charts and data sourced via Bloomberg Finance, LP)

– April 26, 2023

The Fed Is Bankrupt

THOMAS L. HOGAN

Senior Research Faculty

Federal Reserve Chair Jerome Powell recently testified before Congress on the current state of the US economy. In addition to monetary policy, Powell was questioned about the Fed's regulatory proposals regarding cryptocurrencies and climate-related financial risks.

Barely mentioned, however, was the Fed's balance sheet. The Fed has experienced significant operating losses over the last six months, which have exhausted its existing capital. Those losses represent foregone revenue to the US Treasury.

Operating losses

In the post-pandemic period, the Fed expanded the money supply significantly to support a swift economic recovery. It did so by purchasing vast amounts of US Treasury bonds and mortgage-backed securities. While those assets seemed like good investments at first, they are now a major hole in the Fed's financial position.

When the bulk of the Fed's quantitative easing (QE) programs took place in 2020 and 2021, market rates on long-term Treasury bonds fluctuated mostly in the range of 1.5 to 2.0 percent. At the time, the Fed was paying interest on bank reserves and overnight reverse repurchase (ONRRP) agreements of 0.15 or less. The Fed profited on the difference between the higher rate it received from its bond purchases minus the lower rates it paid on reserves and Overnight Reverse Repurchases (ONRRPs).

Now, the Fed has raised the interest it pays to 4.55 percent on ONRRPs and 4.65 percent on bank reserves, but the rates it earns on its QE purchases remain mostly unchanged. Assuming, as a rough approximation, that the bonds it purchased pay an

average rate of 1.75 percent, and the average rate paid on bank reserves and ONRRPs is 4.6 percent, then the Fed is paying about 2.85 percent per year more than it receives on its \$8 trillion dollar securities portfolio. That's a loss of \$228 billion per year!

The bankrupt central bank

The Fed is bankrupt — and I don't just mean intellectually.

Like a private bank, the Fed maintains some level of capital as a buffer against losses. When those losses exceed the value of its capital, the Fed becomes insolvent, meaning the liabilities it owes to others are greater than the total value of the assets it holds.

The most recent data show that the Fed owes the Treasury over \$41 billion, which exceeds its total capital. The Fed, by common standards, is indeed insolvent.

Deceptively deferred assets

What does the Fed do when its liabilities exceed its assets? It doesn't go into legal bankruptcy like a private company would. Instead, it creates fictitious accounts on the assets side of its balance sheet, known as "deferred assets," to offset its increasing liabilities.

Deferred assets represent cash inflows the Fed expects in the future that will offset funds it owes to the Treasury. As the Fed describes, "the deferred asset is the amount of net earnings the Reserve Banks will need to realize before their remittances to the US Treasury resume." The Fed had already accrued \$41 billion in deferred assets, and the amount is only getting larger.

The advantage to deferred assets is that the Fed can continue its normal operations without disruption, although considering the 40-year-high inflation, its recent performance has been less than ideal.

The disadvantage is that, at a time when the Fed is already worsening the US fiscal position by raising interest rates (and therefore interest payments on the federal debt), it is further robbing the Treasury of revenues by deferring them into the future. Those deferred payments, of course, must be shouldered by American taxpayers until the Fed's remittances resume.

These losses may be offset by any previous gains on the Fed's QE portfolio, but assessing the net effects of those actions is even more difficult. QE has created massive distortions in the financial system. The Fed's interest rate tools of interest on bank reserves and ONRRPs have significantly curtailed short-term lending in the banking and financial systems.

A job for Congress?

In addition to its role in managing the money supply, the Fed is the primary regulator of most US banks. If any private bank behaved this irresponsibly, regulators, such as the Fed or Federal Deposit Insurance Corporation (FDIC), would force it to close. Bank managers would lose their jobs and incomes.

Clearly, Congress is not planning to shut down the Fed, and is unlikely to punish it for its poor performance, but there are changes that could be made. The banks that are members of the Federal Reserve System could be forced to cover the capital shortfall, as described in the Federal Reserve Act. The Fed could return to a corridor system of monetary policy, resulting in lower interest paid on bank reserves and ONRRPs relative to market rates and therefore fewer reserves held at the Fed.

Shrinking the Fed's balance sheet would make another Fed insolvency less likely, while also

reducing the Fed's footprint and the distortions it creates in the financial system. At very least, Fed officials should better manage its operations so as not to be a drain on American taxpayers again in the future.

– April 14, 2023

Tax Strike!

ROBERT E. WRIGHT

Senior Research Faculty

As the deadline to file individual federal income taxes looms, some readers might wonder if they receive sufficient services in return for what they pay. Over the centuries, many Americans have answered that question in the negative, and teamed up with their neighbors to do something about it.

The American Revolution was about taxes at one margin, though at root monetary and budgetary policies were to blame. The Stamp Act seemed onerous to the colonists because there was so little money in circulation in 1765 that squirrel-scalp bounties circulated as money in rural Pennsylvania. Also, the colonists wanted to disburse salaries to Imperial officeholders themselves, because they had discovered the “power of the purse” when confronting intransigent Royal and Proprietary governors over the course of the eighteenth century. Withholding their salaries made them so much more pliable.

Soon after Independence, at least three major rural tax revolts took place (Shays, Whiskey, Fries) and many state and local elections hinged on tax matters. The Civil War was primarily about slavery, but Southerners’ hatred of high tariffs, which enriched Northern industrialists at their expense, were certainly a secondary consideration.

So many Americans rebelled over high taxes, in fact, that in the late nineteenth century, statistes rejected the intuitive and venerable “benefit principle” of taxation, which held that taxpayers should pay in proportion to the benefits received, as with use fees and taxes based on the value of real estate under government protection. Statists like Progressive economist E.R.A. Seligman shouted down the benefit principle, arguing instead that taxpayers

should pay based on their ability to do so, regardless of what they perceived that they received in return.

“Every one is equally interested in the State,” Seligman wrote, “because **he cannot exist without the State**. The principle of contribution becomes shifted from that of benefits to that of ability, of faculty, of capacity. Every man now must support the State to the full extent, if need be, of his ability to pay. He does not measure the benefits of State action to himself” [emphasis mine].

Progressives managed to pass a constitutional amendment and establish a federal income tax with so-called “progressive” rates that increase with income. Nevertheless, many Americans did not come to believe that their very existence depended upon the government and wanted something in return for their hard earned cash. They stopped rebelling though, and started legally avoiding or illegally evading taxes by hiding income and/or finding loopholes, which abounded due to the Progressive predilection of trying to use the tax code as a tool of social policy.

Real estate taxes, though, were more difficult to dodge. During the Great Depression, governments pushed hard to collect real estate taxes needed to pay for government programs and make up for declining income tax receipts. Many real estate taxpayers pushed right back. In Manhattan, for example, the West Side Taxpayers’ Association encouraged taxpayers to delay paying until municipal employees’ salaries were cut (the prices of consumer goods had plummeted after all) and their assessments revised to reflect recent real estate market declines.

The greatest Depression-era tax “strike” of them all, though, took place in Chicago. Led by former

tax collector and Georgist John Morgan Pratt, the Chicago Association of Real Estate Taxpayers (CARET) rallied 4,000 taxpayers to file protests with the city's real estate review board on a single day, 29 November 1930. When a lower court ordered the board to review appeals from an estimated 30,000 taxpayers, tax collection efforts shut down for two years.

Bankers, union leaders, and Chicago's mayor, Anton Cermak, eventually convinced newspapers to refuse the tax strikers news coverage and even paid advertisements, and instead to donate ad space to "Pay Your Taxes Savings Clubs." Then, in late 1932, the US Supreme Court refused to hear CARET's test case, exposing the strikers' tax-delinquent real estate to sheriff sale. By early 1933, many of those who could pay, did, and the strike was broken. That was just in time for the New Deal, which tripled taxes to fund a huge number of experimental government programs that ensured both Franklin Delano Roosevelt's reelection and continued high levels of unemployment.

Today, no American would dare to attempt a tax strike, much less a tax rebellion, no matter the disconnect between what they pay and what they receive in return, even if, "like a Neanderthal," they still adhered to the benefit principle. A more serious threat to the Republic is that of rapacious tax collection, like that of the infamous "tax farmers" of France's Ancien Regime.

After all, a dozen state governments today readily seize and sell real estate worth even a thousand times more than the tax debt due and keep the excess. Moreover, anyone can lose his automobile or home without a criminal conviction if a little bit of the wrong substance magically appears in the asset during a law enforcement search. And there is little anyone can do to thwart collection of the most insidious tax of all: inflation.

The American Bar Association assures Americans that the planned 87,000 new Internal Revenue

Service (IRS) agents will not bust through your door this year, because it takes a couple of years to train them up, the labor market remains tight, and IRS human resources practices are very good but necessarily slow. Moreover, for political reasons, the beefed-up IRS probably will not cause serious trouble until processing 2024 returns in 2025. Unless, that is, taxpayers rebel the only way they still can, via the electoral process, starting with candidate selection.

– April 2, 2023

Silicon Valley Bank: Mismanagement Is Not an Excuse for Inefficient Regulation

NICOLÁS CACHANOSKY

Senior Fellow, Sound Money Project

According to Michael Barr, the vice chair for supervision at the Federal Reserve, Silicon Valley Bank's failure was a "textbook case of mismanagement." Perhaps that's unsurprising. Regulators are unlikely to conclude that the second-largest bank failure in American history was due to inefficient regulation. What did SVB management do? Why did they do it? And, was the problem purely inadequate management?

To understand SVB's fall, we must look at its assets and liabilities. A typical commercial bank's liabilities include a large number of small, insured deposits. This strategy is basic risk diversification. By dealing with many small deposits, a few withdrawals will not affect the bank's financial situation. The risk of a bank run is minimized.

SVB, in contrast, served a small number of large, uninsured accounts. Additionally, many of these accounts came from the same risky industry: new, venture-capital-funded, IT firms. SVB concentrated its risk on larger deposits from one sector with risky startups.

On the asset side, SVB held a large number of US Treasury bonds. A bank uses market values (mark-to-market) to account for the bonds it plans to sell before maturity. Alternatively, it can mark the bonds at face value if it intends to hold them until maturity.

Interest-rate movements affect the mark-to-market valuation, but not the face value of the bonds held until maturity. The Fed's rapid increase in interest rates pushed the market yield on US Treasuries to its highest levels in the last decade. With high exposure to a struggling sector, SVB had to sell more US treasuries than it had anticipated.

Some of the bonds initially intended to be held to maturity had to be marked-to-market, exposing substantial financial losses. Seeing these losses, uninsured depositors rush to move their funds out of SVB. The rest, as they say, is history.



It is not apparent, however, that SVB's failure was purely a case of mismanagement. Regulators cannot forget that banks (like any other firm) react to regulatory incentives and expectations. The market has come to expect large financial institutions will be bailed out if necessary, with the recent joint statement by the Fed, Treasury, and FDIC affirming that view. Financial institutions believe profits will be private, while the costs of failure will be socialized. This environment is not the outcome of a free market. It was a policy choice.

Now, there are calls to expand deposit insurance—with some arguing that *all* deposits should be covered. That would be a step in the wrong direction. "[D]espite the common perception among both laymen and economists that deposit insurance helps stabilize the banking system," Thomas Hogan and Kristine Johnson write, "most empirical studies find deposit insurance decreases stability." Expanding deposit insurance would make this worse, with banks responding by taking on *even more* risk.

SVB's management strategy is no excuse for supporting or expanding inefficient regulation. The

mismanagement was endogenous to the regulatory regime. Rather than promoting financial stability, regulators have undermined it. Doubling down on a failed strategy will not make things better.

– April 3, 2023

The Tax Code: A Playground for the Few, A Labyrinth for the Many

ANTONY DAVIES

Contributor

Each year, Americans pay tax preparers billions of dollars to file our taxes. Though 70 percent of us qualify to file our taxes for free, few of us do. Part of the reason is that the tax code has become so convoluted, and the ramifications of erring so onerous, that tax preparers have become almost a priestly class of intercessors between the IRS and taxpayers. We dare not risk the wrath of the IRS by approaching it without an advocate.

And yet, most of us are simply reporting numbers that the IRS already has. How do we know? Because if we report the numbers incorrectly, the IRS will tell us so. For many of us, filing our taxes is not about reporting our incomes so much as providing the IRS with free secretarial support.

While a dangerous pain to taxpayers, the cesspool of confusion, inefficiency, and manipulation that is the federal tax code won't be simplified, because the code delivers a cornucopia of benefits to lawyers, tax accountants, favored industries, lobbyists, and politicians.

The benefits to lawyers and tax preparation services are obvious. The IRS estimates that the average taxpayer spends \$240 just to file his federal tax return. For 158 million federal tax returns, the annual cost of complying with our byzantine code approaches \$40 billion. But in most cases, the tax code is a make-work program. Congress digs legal holes, and we pay lawyers and accountants billions of dollars annually to fill them back in again.

Favored industries and lobbyists benefit more subtly. The more intricate the tax code, the easier it is for politicians to hand out favors to their preferred groups without attracting attention. Granting special tax treatment to a favored industry is as simple as

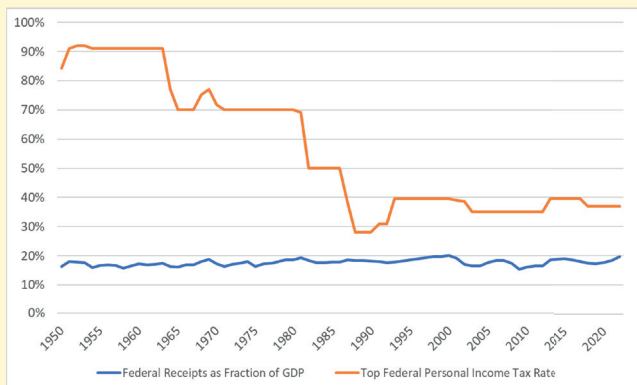
hiding a needle composed of a few choice sentences in a 70,000-page haystack. Industries pay lobbyists to encourage politicians to hide these needles away from public view, and the politicians receive political and financial support from the industries in return. This symbiotic relationship among favored industries, lobbyists, and politicians thrives in an environment of complexity.

Meanwhile, complexity benefits the politicians both coming and going. While politicians receive support from industries by hiding gifts in the tax code, come election season, politicians decry the tax code and promise voters they'll fight the complexity on the voters' behalf. Politicians vilify corporations, promising to close tax "loopholes" that benefit the rich and powerful, while counting on voters not to notice that those same politicians created the loopholes in the first place. Politicians pledge to tax corporations, while counting on voters not to notice that every tax on a corporation gets passed on to voters in the form of higher prices, lower wages, or lesser returns. Politicians vow to make the rich pay their fair share, while counting on voters not to notice that the richest 10 percent of taxpayers already pay almost 75 percent of all federal income taxes.

Politicians create the problem of a complex tax code and then present themselves to voters as its solution.

The real solution is simplification. A straightforward, easily understood tax code would reduce lobbyists' and industries' influence by making it more difficult for politicians to hand out special favors without the public noticing. Simplification would save taxpayers billions in time and money, and would allow the IRS to focus its resources on collecting dollars rather than collecting paperwork.

Interestingly, history provides a suggestion for straightforward simplification in what economists know, informally, as “Hauser’s Law.” It turns out that, for the past seventy years, it hasn’t mattered whether Congress taxed the rich or the poor, whether it taxed corporations or individuals, whether it taxed capital gains or wages, whether it taxed a lot or a little. The result has always been the same: The federal government has collected around 18 percent (plus or minus 2 percent) of the economy in tax revenue.



Data source: Federal Reserve Bank of St. Louis.

If 18 percent is the answer, regardless of the simplicity or complexity, let’s opt for simplicity and tax all income at 18 percent — no deductions, no exemptions, no credits, no caps, no different treatments for wages and capital gains.

The problem is that, even if politicians, lobbyists, lawyers, and tax accountants were in favor, we’d still end up with a complex tax code. Why? Because we all want a simplified tax code with the exception of our favorite carve-outs. Homeowners will say it’s not fair that they can’t deduct mortgage interest. Investors will say it’s not fair that capital gains should be taxed the same as wages. Those with chronic medical conditions will say that it’s not fair to lose their medical-expense deductions. The poor and middle classes will say that it’s not fair for them to pay the same tax rate as the rich.

While few benefit from a complex tax code as much as do politicians and those in political orbits, we each benefit a little bit in many different, small ways. Keep each of those different, small ways and we’re back to a complex tax code.

Alternatively, replacing the federal income tax with a national sales tax would shift the tax burden to consumption rather than income. When we grow angry about what we believe the rich should pay, we tend to picture the idle rich, living a high life off of passive income. What we don’t picture are hard-working middle-class people who have amassed wealth through perseverance and frugal living. An income tax hits the frugal and industrious. A consumption tax hits the idle spendthrifts. The major hurdle here is that a national sales tax would likely require a constitutional amendment. And, if we didn’t simultaneously repeal the 16th Amendment, which established the income tax, we’d end up with both a national sales tax and an income tax. A consumption-based tax would be more visible to consumers, as they would see the tax applied every time they purchased something. This would make it more difficult for politicians to hide tax favors and more difficult to sneak in tax increases.

The tax code’s complexity has created an environment in which tax-preparation services, lobbyists, favored industries, and politicians thrive, while taxpayers struggle to make sense of ever-changing rules and regulations. A reformed tax system would not only save taxpayers time, money, and frustration, but would also reduce opportunities for the powerful to co-opt the tax code to their benefit. Businesses would focus more on growth and innovation, instead of on co-opting a labyrinthine tax code. Entrepreneurs would focus more on attracting consumers rather than attracting politicians. Politicians would focus more on satisfying constituents rather than satisfying lobbyists. Lobbyists would find less demand for their services, and the many smart

people who serve as tax lawyers and tax accountants would redirect their efforts to creating value, rather than counteracting problems Congress creates for the rest of us.

– April 18, 2023

The Climate Collapse Thesis

MAX BORDERS

Contributor

In 2003, someone leaked a “secret” Pentagon report warning of the dire consequences of climate change.

“Disruption and conflict will be endemic features of life,” it reads. “Once again, warfare would define human life.”

The report’s authors offer dramatic examples, including the claim that “catastrophic” shortages of potable water and energy would lead to widespread war by 2020. Britain would have winters similar to those in Siberia as European temperatures drop off radically by 2020.

In 2017, there was a war in Yemen. But it wasn’t all that widespread. And Yemenis experienced water shortages, but not war due to a shortage of water.

Britain underwent milder winters in 2015, and there were slightly colder winters in the five years prior.

So 2020 came and went.

Of course, a credulous press, eager to propagate the dire warnings, had been happy to report what turned out to be false predictions. In other words, we never did get catastrophic water shortages and permafrost in Britain. How could the authors have gotten things so wrong?

To give you a better idea, let’s zoom out.

Imagine we’re in a low intellectual orbit, high enough to get a wide shot but low enough to see some things. From this macro perspective, we want to evaluate a set of claims about climate change that we must connect to form a coherent theory. Let’s take some familiar premises from what we might term the Climate Collapse Thesis and view them in their totality.

To accept the Climate Collapse Thesis – that climate change ought to be seen as the number one potential driver of catastrophe – we have to accept *all* of the following hypotheses:

1. The earth’s atmosphere and oceans are warming.
2. The earth is warming primarily due to emissions like carbon dioxide and methane, generated by people engaging in production, trade, transportation, and energy use.
3. Scientists can limn the most important phenomena associated with a warming climate, and disentangle human causes from natural ones, extending into the distant past.
4. The data gathered and then aggregated by the scientists are overwhelmingly error-free, and the scientists operate free of biases when packaging and presenting their data. (This special group of scientists suffers neither from a peer-review nor a replication crisis, and they are immune to the perverse incentives of government funding.)
5. Even though individual scientists are working separately on different aspects of climatology and related fields, they can stitch these diverse aspects together into one complementary dataset, supporting a single, coherent hypothesis *up to this point*.
6. Scientists can then use computer models to simulate most of the phenomena associated with the earth’s warming and make reasonable predictions, within a degree or two, about a hundred years into the future.
7. A different group of scientists can repackage that packaged information and make certain predictions about the dangers that a couple of

degrees of predicted warming will make over that hundred years, say to glaciers, farmland, and sea levels.

8. Social scientists, including economists, can then repackage – without loss of accuracy or the introduction of error – the aforementioned global predictions and make yet further predictions about the costs (and benefits) accompanying those predictions. Of course, the relevant subset of these portends either ecosystem collapse, social collapse, or both (and that subset is appropriate to the Climate Collapse Thesis in this context).
9. Based on what the world *might* be like if that different group of scientists and the social scientists turn out to be correct, policy wonks can, in turn, accurately predict what the world will be like *if specific climate policies are implemented*. And these policies minimize those effects the social scientists predicted.
10. Policymakers can then take the prior groups' predictions and set policies that will mitigate the predicted warming (and subsequent collapse). Such will ensure that what's best for the people and planet – on net – is balanced against other important considerations.
11. The policies, once imposed, will be implemented such that they work as intended. And all major emitting nations must cooperate close to global unanimity. That means there should be no defections, corruption, or false reporting by such trustworthy authorities as China's Communist Party.
12. Abatement of greenhouse gas output has a real effect on the rate of climatic change, enough to pull the world out of danger, including climate collapse.
13. Those policies are worth the costs they impose on the world's people, especially the poorest.

I repeat: to accept the Climate Collapse Thesis, we have to accept *everything* above.

Yet the interdependencies are staggering. It's not just possible but probable that any one of these linkages will break. A humbler interpretation of climate change science and policy, far from being a conspiracy of denialists, turns out to be an imperative of reason.

Let's assume the Climate Collapse Thesis is a falsifiable theory. We can calculate the compounded uncertainty. Assuming that the relevant "experts" are 95 percent certain of each of the thirteen hypotheses above, compounding the uncertainty would not yield a result of 95 percent.

Not even close.

My envelope calculation shows a 51.3 percent chance that the Climate Collapse Thesis is correct – a coin flip.

Now, if we agreed that we have a 51.3 percent chance of climate collapse, it might be enough to persuade reasonable people that we must *take action*, whatever that means. But my envelope calculation doesn't include a critical aspect of the Climate Collapse Thesis: interdependence.

My envelope method not only accepts the highly subjective 95 percent certainty per hypothesis *at face value* (itself highly dubious) *but treats each hypothesis independently*. But the thirteen premises are *interdependent*.

The problems don't stop there.

As one might inspect a fractal, we can zoom down into each of the above claims and check another set of interdependencies. Whether on the Science™ or policy implementation, the likelihood someone will introduce an error is high. The chain of claims to "settled science," plus policy prescriptions, is like an enormous Chinese Telephone game. While it is true that we could spend multiple volumes evaluating each of these interdependencies in-depth, it's enough here to point out the problem: *compounded uncertainty*.

At the very least, our questions about climate science-cum-policy lie in stark contrast to the claims of those predicting catastrophe.

Consider the words of catastrophe expert Jem Bendell, who writes:

“The field of climate adaptation is oriented around ways to maintain our current societies as they face manageable climatic perturbations.... The concept of “deep adaptation” resonates with that agenda where we accept that we will need to change, but breaks with it by taking as its starting point the inevitability of societal collapse.”

We’re all going to die. We need to “change” anyway.

In response to my critique of the Climate Collapse Thesis, one might offer a variation on Pascal’s Wager or the Precautionary Principle – that is, we can’t take the risk because there is uncertainty amid the complexity. We must act to mitigate risks, come what may, lest we go to Hell.

Isn’t it possible, though, that the sort of draconian “action” being proposed could, from a human systems perspective, send us to a different kind of Hell?

Questions surrounding climate change are hardly in isolation. They are deeply interconnected. Most climate-change alarmism hinges on models that are not reality.

Some measure of humility is in order.

The COVID-19 pandemic showed what can happen to a society that is being shut down in the name of saving humanity. That was but a taste of what the powerful will do if we accept the Climate Collapse Thesis and all the “action” that comes with it.

– April 12, 2023

Inflation Slowed in February, But Remained High

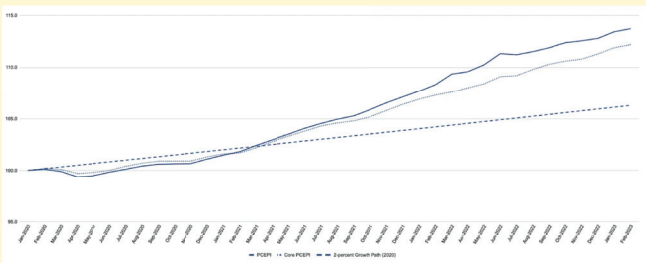
WILLIAM J. LUTHER

Director, Sound Money Project

After two worrisome months, we are finally getting some better news on the inflation front. The Personal Consumption Expenditures Price Index (PCEPI) grew at a continuously compounded annual rate of 3.2 percent in February, down from 6.9 percent in January. PCEPI inflation was just 2.1 percent in November 2022 and 2.4 percent in December 2022. Monthly inflation in January was the highest it had been since June 2022. Although inflation is still 1.1 percentage points higher than it was in November 2022, it is at least headed in the right direction.

Core PCEPI, which excludes volatile food and energy prices and is believed to be a better predictor of future inflation rates, also declined. Core PCEPI inflation was just 3.6 percent in February. In January, core PCEPI grew 6.2 percent—1.7 percentage points faster than in December 2022 and 3.5 percentage points faster than in November 2022.

Figure 1. Headline and Core PCEPI, January 2020 – February 2023



The PCEPI price level has grown at a continuously compounded annual rate of 4.2 percent since January 2020, just prior to the pandemic. As a result, prices are 7.4 percentage points higher today than they would have been had the Federal Reserve hit its 2 percent inflation target over the

period. Core PCEPI has averaged 3.7 percent growth over the period.

Although inflation remains elevated, it finally appears to be consistent with Federal Open Market Committee (FOMC) member projections. The median FOMC member increased their 2023 inflation projection from 3.1 to 3.3 percent in March. However, lower than projected inflation in the last two months of 2022 means the implicit price level projection for December 2023 is more or less unchanged.

FOMC members consistently underestimated inflation from June 2020 to December 2022, and were forced to revise up their projections each quarter.

Table 1. Median FOMC Member Inflation Projections

Projection Date	2021	2022	2023	2024	2025	Longerrun
June 2020	1.6	1.7				2.0
September 2020	1.7	1.8	2.0			2.0
December 2020	1.8	1.9	2.0			2.0
March 2021	2.4	2.0	2.1			2.0
June 2021	3.4	2.1	2.2			2.0
September 2021	4.2	2.2	2.2	2.1		2.0
December 2021	5.3	2.6	2.3	2.1		2.0
March 2022		4.3	2.7	2.3		2.0
June 2022		5.2	2.6	2.2		2.0
September 2022		5.4	2.8	2.3	2.0	2.0
December 2022		5.6	3.1	2.5	2.1	2.0
March 2023			3.3	2.5	2.1	2.0

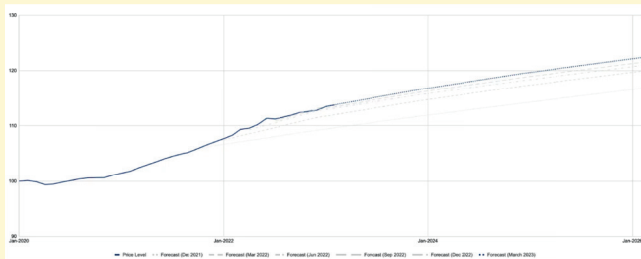
Morgan Timmann and I estimate the price level based on FOMC member projections. If the price level evolves as the median FOMC member suggests it should, prices will be 16.8 percent higher in December 2023 than they were in January 2020, reflecting 3.9 percent average inflation over the period. Prices will be 19.6 percent higher in December 2024, with the average inflation rate from January 2020 to January 2024 falling to 3.6 percent. They will be 22.2 percent higher in December 2025, with average annual inflation since January 2020 of 3.3 percent.

a recipe for higher-than-target inflation on average, and will fail to anchor long run inflation expectations at 2.0 percent as intended.

Recent experience should prompt calls for the Fed to adopt a symmetric average inflation target when it reevaluates its mandate in 2024 and 2025.

– April 1, 2023

Figure 2. Forecast of the Price Level based on Median FOMC Member Projections



Fed officials have no intention of bringing prices back down to where they would have been had they not grown faster than intended since January 2020. They merely intend to reduce the growth rate of prices to 2.0 percent going forward. They do not project the annual rate of inflation will return to 2.0 percent until after 2025. The average inflation rate since January 2020 will only approach 2.0 percent in the very, very long run.

Many Americans believe inflation has been too high over the course of the pandemic—and I count myself among them. But temporarily higher inflation and permanently higher prices is totally consistent with the Fed’s asymmetric average inflation target, which commits monetary policymakers to make up for undershooting their target but does not require they make up for overshooting their target. This is

Patrick Henry's Stamp Act Resolutions

JAMES R. HARRIGAN

Senior Editor

On May 29, 1765, Patrick Henry offered five resolutions on the floor of the Virginia House of Burgesses in response to the much-reviled Stamp Act, which had followed on the heels of the nearly as-reviled Sugar Act. The Resolutions were adopted in Virginia, then quickly found their way into the political vernacular of a number of other colonies, giving rise to what would become the colonists' rallying cry: no taxation without representation.

Henry had seven resolutions. Five passed on May 30, and he pocketed the last two after the heated debate over the fifth. After Henry left town, the House of Burgesses expunged the fifth Resolve on the 31st. It only remains with us because it was found in an envelope alongside Henry's will.

As we all know, a Revolution ensued. Over taxation without representation.

So how much were the colonists paying at the time? 1-1.5 percent.

1-1.5 percent

It turns out that taxation *with* representation is nothing to write home about, either.

The Virginia Stamp Act Resolutions

Resolved, that the first Adventurers and Settlers of His Majesty's Colony and Dominion brought with them and transmitted to their Posterity, and all other His Majesty's Subjects since inhabiting in this his Majestie's said Colony, all the Privileges, Franchises, and Immunities that have at any Time been held, enjoyed, and possessed by the People of Great Britain.

Resolved, that by two royal charters, granted by King James the first, the Colonists aforesaid are declared intituled to all the Privileges, Liberties & Immunities of Denizens and natural-born Subjects to all Intents and Purposes as if they had been abiding and born within the Realm of England.

Resolved, that the Taxation of the People by themselves, or by Persons chosen by themselves to represent them, who can only know what Taxes the People are able to bear and the easiest method of raising them, and are equally affected by such Taxes themselves is the distinguishing Characteristick of British Freedom and without which the ancient Constitution cannot subsist.

Resolved, that His Majesty's liege People of this most ancient Colony have uninterruptedly enjoyed the Right of being thus governed by their own assembly in the article of their Taxes and internal Police, and that the same hath never been forfeited or any other way given up but hath been constantly recognized by the Kings and People of Great Britain.

Resolved, therefore that the General Assembly of this Colony have the only and sole executive Right & Power to lay Taxes & Impositions upon the Inhabitants of this Colony and that every Attempt to vest such Power in any person or Persons whatsoever other than the General Assembly Aforesaid has a manifest Tendency to destroy British as well as American Freedom. (ultimately not adopted.)

– April 18, 2023

A Tragedy in Waiting

JASON SORENS

Senior Research Faculty

The state of Washington just enacted a package of sweeping gun regulations, including an assault weapons ban, a 10-day waiting period for all firearms purchases, and mandatory training for buyers. People are focusing on Olympia's assault weapons ban, but the most invasive part of the bill is the waiting period.

Waiting periods for firearms purchases disarm murder victims. Who needs a legal firearm urgently? Someone dealing with a stalker, or perhaps a woman fleeing an abusive relationship. In those situations, you can't rely on the police to provide 24/7 security.

Now, maybe you think the waiting period will prevent more murders than it causes. That's doubtful, because criminals generally can't pass the background check and get their weapons on the black market or by stealing them.

But let's suppose it's the case. The waiting period is still a grave injustice. A thought experiment from philosophers Todd Hughes and Lester Hunt shows us why.

They ask us to imagine a victim of a violent attack, such as a home invasion. Legally and morally, the victim has a right to fight back, including with a gun, if she has one. The victim's only responsibility is to stop the attack. Now imagine the attacker has an accomplice. The accomplice grabs the victim's gun and prevents her from firing it.

Is the accomplice acting rightly or wrongly here? Surely disarming the victim by taking away her gun is wrong. It makes the accomplice share the responsibility for whatever happens to the victim. Disarming a victim to allow murder to take place is itself murder.

Now imagine that instead of a criminal's taking away the victim's gun, it's the government. The

victim never had a gun, because she couldn't get one in time. The attacker is then able to complete the crime, because the victim lacked effective means of self-defense. Doesn't this make the government an accomplice to the crime? What's the moral difference between disarming a murder victim in advance of the crime and disarming the murder victim during the crime?

When the government violates fundamental rights, it doesn't matter whether there is a small, net social benefit to doing so. It's still wrong. Taking away someone's means of self-defense, making her vulnerable to criminal attacks, is a violation of that person's rights. Waiting periods for gun purchases do precisely that.

Since defensive gun uses across the country range in the hundreds of thousands to millions per year, it's a virtual certainty that at least one person will lack the means of deterring or fighting back against an attacker because of Washington's 10-day waiting period. That makes the new policy a grave injustice, regardless of what the courts may rule about its constitutionality.

– April 28, 2023

Yes, the Fed Is a Failure

ALEXANDER WILLIAM SALTER

Senior Fellow, Sound Money Project

Governor DeSantis recently took aim at the Federal Reserve, presumably to bolster his national-issues profile ahead of announcing a run for the presidency, which he is expected to do in May. He lambasted both Chairman Powell's leadership and the nascent moves towards a central bank digital currency (CBDC). DeSantis apparently wants to demonstrate his populist *bona fides*. He may even be trying to recapture some of the energy of Ron Paul's "End the Fed" campaign from more than a decade ago.

The usual suspects are accusing DeSantis of spreading "misinformation" about the Fed's effectiveness and activities. But it's they who are misinformed. The Fed truly is a basketcase. It has persistently failed to achieve its basic mandate and has strayed into policy areas far outside its legal authority and core competence. And the United States is worse off for it.

The Fed is required by Congress to pursue stable prices and full employment. It is bad at both. Ongoing inflation demonstrates our chief central bankers never learned the lessons of the late 1970s. And the fixation on real variables such as employment — especially among "disadvantaged" groups — caused the Fed to lose sight of the one thing it can actually control: the purchasing power of the dollar.

For two years, inflation has exceeded nominal wage growth, meaning the typical American has taken a real pay cut: He receives less purchasing power for an hour of work than he did two years ago. This is, indeed, the Fed's fault.

Comparing the pre-Fed to the post-Fed periods, it's clear the Fed is no improvement at best and a detriment at worst. Inflation is not persistently lower.

Recessions are not persistently shorter. The only metric that comes down in the Fed's favor is inflation volatility — and this is due to pre-Fed public-finance practices, not the wisdom of central bankers.

Inflation volatility was higher during the 19th century because the government suspended the gold standard to fight wars. Printing greenbacks was a revenue-raising strategy. Once wars ended and redemption resumed, the economy gradually grew into the higher price level, bringing inflation down. The Fed deserves precisely zero credit for this.

As for a CBDC, it's undeniable that the Fed has been experimenting with pilot programs, which Congress has not authorized. It's also clear a CBDC would be a disaster for financial privacy and political liberty.

Who in their right mind wants the government to control the payments process? The government would certainly abuse it, stifling payments to disfavored producers and perhaps even taxing CBDC balances to artificially boost consumption. We don't want or need a financial panopticon. If the Fed won't stop this dangerous experiment on its own, the people's representatives should.

We have every reason to worry about Fed wokeness, too. The central bank's research output and governance initiatives related to amorphous and partisan goals, such as DEI and climate change, demonstrate a frightening level of mission creep. Let me put it bluntly: The Fed has no authority to act in these areas. Any connection to the monetary mandate, or its related financial-stability mandate, is an illusion.

The Fed has repeatedly shown it can't even be trusted to manage the money supply responsibly.

Why would one expect the Fed to make a positive contribution to environmental sustainability or social justice? Calling this implausible is a massive understatement.

Government agencies should serve the public interest while upholding the rule of law. The Fed does neither. It needs major reforms to put it back on track.

The Fed's monetary mandate should be constrained by a strict rule. Its financial mandate should be tightened so that Fed bureaucrats no longer have an excuse to use their jobs for social activism.

DeSantis is right to call out the Fed. And honesty compels one to acknowledge the Fed's failures, even if those failures are pointed out by politicians of whom one disapproves. Anything less subjects responsible policy analysis to rank partisanship.

– April 24, 2023

De-dollarization Has Begun

PETER C. EARLE

Research Faculty

Last week, China and Brazil reached an agreement to settle trades in one another's currencies. Over the past 15 years, China has replaced the United States as the main trading partner of resource-rich Brazil, and as such that shift may have been inevitable. But within the context of recent circumstances, this appears to be another in a series of recent blows to the central role of the dollar in global trade.

As the world's reserve currency, the US dollar is essentially the default currency in international trade and a global unit of account. Because of that, every central bank, Treasury/exchequer, and major firm on Earth keeps a large portion of their foreign exchange holdings in US dollars. And because holders of dollars seek returns on those balances, the ubiquity of dollars drives a substantial portion of the demand for US government bonds in world financial markets.

The switch from dollars to a yuan-real settlement basis in Chinese-Brazilian trade is only the latest in a growing trend. Discussions of a more politically neutral reserve currency have gone on for decades. The profound economic disruption experienced by Iran, and more recently Russia, after being evicted from dollar-based trading systems like SWIFT, however, have led many nations to consider imminent contingency plans. India and Malaysia, for example, have recently begun using the Indian Rupee to settle certain trades, and there have been perennial warnings about Saudi Arabia and other energy exporters moving away from the dollar. On that note, China also recently executed a test trade for natural gas with France settled in yuan.

DXY Index (1980 – present)



[Source: Bloomberg Finance, LP]

It's not just the conscription of the dollar in economic warfare, but increasingly error-fraught monetary policy regimes that are driving various interests away from the greenback. The monetary policy response to the 2008 financial crisis saw the dollar's value whipped around unpredictably, and the response to the outbreak of COVID was even more frenetic. The massively expansionary response to the pandemic in 2020 was followed by an initially dismissive posture toward the outbreak of inflation, which reached four-decade highs before an aggressive contractionary shift in policy that destabilized precarious financial institutions was implemented.

Simply replacing the fiat currency of the largest economy in the world with the fiat currency(s) of (a) smaller economy(s) is hardly a viable replacement strategy. Moving away from the dollar brings substantial barriers to exit as well as network effects to overcome, owing to historical, technological, financial, and habitual obstacles. The US dollar is the *de facto* currency of East Timor, Ecuador, El Salvador, the Federated States of Micronesia, the Marshall Islands, Palau, Panama, and Zimbabwe.

Further, the (comparatively, relatively) transparent conduct of monetary policy in the US has led no less than 22 foreign central banks and currency boards to peg their currencies to it. And dollars are the cheapest means of access to acquire nominally risk-free US Treasury instruments.

Bloomberg Dollar Spot Index (2005 – present)



(Source: Bloomberg Finance, LP)

Some of the “twists” being discussed to provide alluring dollar replacements are cryptocurrencies, central bank digital currencies, or baskets of commodities representative of a given nation or region’s competitive advantage. The latter scenario, in which (for example) certain African nations would trade in currencies backed by titles to rare earth metals, some South American nations in currencies backed by copper deposits, and so on, is interesting but faces substantial hurdles. Nevertheless, a conference in New Delhi last week focusing on increased cooperation between Brazil, Russia, India, China, and South Africa touched on just such a plan. Variations of such a currency order have been dubbed “Bretton Woods III,” and some non-commodity proposals bear a curious similarity to the since-discarded Facebook currency plan first called Libra (later, ‘Diem’).

Owing to the role that dollar pervasiveness plays in the international appetite for US Treasuries, a side effect of the long-term attempt to establish alternative reserve currencies may be decreasing interest in tradable US debt. Over shorter time frames, that

would likely result in higher yields and higher levels of debt service on securities issued by the US Treasury. Over generational time frames, that shift could force a reduction in US government spending. Should that scenario play out, the long-term effect of using access to dollars as a bludgeon of American foreign policy could well be higher average inflation and/or higher taxes on American citizens.

The dollar, in some shape or form, will likely be around for a long time. Perhaps very long. But by weaponizing dollar dominance and permitting expanding mandates to disorient US monetary policy, the dollar’s fate as the *lingua franca* of world commerce over the long haul may already be sealed. So long as the political will to moor US fiscal and monetary policies to those consistent with the constitution of sound money remain an inconvertible matter, de-dollarization will proceed. And slower or more quickly, the dollar will lose ground abroad.

– April 4, 2023



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