EUROPE'S CENTURY OF CRISES UNDER DOLLAR HEGEMONY

A Dialogue on the Global Tyranny of Unsound Money

Brendan Brown
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In memory of Irene Brown
Brendan Brown
To Marie Solies
Philippe Simonnot

Invitation to Our French-Speaking Readers

How to Access the Original French Content of This Book

If you would like to read the questions and conclusion by Philippe Simonnot in his original French, these can be found in the Appendices at the end of the book. These are also available to download on SpringerLink.

Brendan Brown
Philippe Simonnot

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Part I

Introduction

1

The Tyranny of Unsound Money

In a sentence which Milton Friedman made famous, J.S. Mill wrote: "most of the time the machinery of money does not matter but when it gets out of control it becomes the monkey wrench in all the machinery of the economy" (Friedman 2006). In the century of US dollar hegemony, since the breakdown of the international gold standard during the First World War, money has mattered most of the time because it has been almost continuously out of control. Money has been profoundly unsound.

Unsound money has spawned and enabled tyranny in multiple ways. Sometimes the link runs from the generating of bubbles and busts to devastating geopolitical consequences. The extreme example here was the role of a massive bubble in stocks and global credit fuelled by the Federal Reserve and its subsequent burst in the Weimar Republic's collapse. Other times political malaise forms due to unsound money's destruction of opportunities for general sustained advances in economic prosperity over long periods.

Always, under unsound money regimes, the state gains tremendous power to obtain revenue without explicitly levying new taxes or hiking old taxes. Monopolists and would-be monopolists use bubble finance as generated by monetary inflation—including fantastically priced equity issues to investors mesmerized by speculative narratives of vast eventual profit margins—to crush free market competition. Historical examples extend from the Dutch East India Company in seventeenth-century Holland to the notorious list of suspects under anti-trust investigation in the US at the start of the 2020s. Monopoly power is inimical to free society.

Individuals constrained by laws and practice to use fiat monies whose issuers pursue monetary inflation are exposed to the huge risks of sudden evaporation of their financial well-being, whether from asset inflation

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turning to asset crash, or from the outbreak of goods and services inflation. Widespread economic and financial suffering imperils always fragile liberty. The propaganda machine of the tyranny (including the central banks and their "transparent communications") grinds on relentlessly. In sum, the severe ways in which "the machinery of money" has acted as monkey wrench go well beyond anything that J.S. Mill imagined or Milton Friedman described.

How to Judge Monetary Soundness

The essence of sound money is its high quality services (store of value and medium of exchange) produced by "machinery" (as in J.S. Mill quote) under the continuous control of automatic mechanisms. These are well protected from governments or other authorities (including central banks) who would tamper with them in pursuit of wider objectives including general economic policy and taxation. Beyond that general statement, what are the criteria by which we should judge the soundness of an actual monetary regime?

There should be a clear and well-understood pivot or anchor to the monetary system. This takes the form of monetary base for which a broad and stable demand exists over the long run, and whose supply is strictly limited. Automatic mechanisms determine and enforce those limits. The mechanisms operate within the context of constitutional rules sometimes including a pledge of convertibility into gold, other metals, or real assets.

Short- as well as long-term interest rates are set wholly by market forces, without official fixing or manipulation. Prices of goods and services are observed to fluctuate widely, sometimes over sustained periods, downwards and upwards, but show a tendency to revert to the mean over the very long run, as determined by the pivot or anchor. There can be no assurance that this mean is constant. There should be widespread conviction, though, that any drift upwards or downwards in this mean will be well-bounded and at any point in time the prospects of an upward drift over the long run should be equal to those of a downward drift.

As illustration under the pre-1914 gold standard it was possible that big new gold discoveries could bring an upward drift in the long-run mean to prices; but it was equally possible that a secular growth in demand for money and trends in the gold mining industry (lack of new discoveries or new technologies) could bring a downward drift.

By contrast, the essential aspects of unsound money include manipulation of interest rates by the government or its central bank (there exists a wide spectrum of possible manipulation practices), the absence of an anchor to the monetary system, and a fixation of the monetary policy makers on stabilizing prices

(the so-called price level or the inflation rate) whilst moderating the fluctuations of the business cycle (in the process, lengthening economic expansions).

The ways in which the monkey wrench jams up the economic machinery go far beyond the traditional (and sometimes misplaced) concerns of consumer price inflation (or deflation) or violent business cycle fluctuations. The starting point (for the monkey wrench) is the haywire signalling of prices, particularly in asset markets. This leads on to a general malfunctioning of the invisible hands, together with misallocation of resources—especially capital.

The false signalling guides capital into a whole range of projects far more intensely than what would have occurred otherwise (with correct signalling). The resulting opportunity losses in prosperity from such malinvestment are potentially huge and long-lasting, even though there might be for a considerable periods of time some apparent benefits to consumers. Extraordinarily low-cost capital to some firms, reflecting wild speculative narratives about future monopoly profits, allows these to gain market share by predatory action, including extended periods of cheap pricing and also systematic elimination of any new entrant challenger by pre-emptive buyouts.

Sound and Unsound Exits from the False Dawn of Monetarism

Sound money requires skilful architecture and construction. By contrast, the monetarism as pioneered by Milton Friedman rested on a firm belief in positive economics (see Friedman 1966). There it is for the economic scientist to find out whether a stable demand function could be reliably estimated for a money supply aggregate, having once selected this in the given monetary and banking system. If successful, then the task of the monetary authorities would be to keep the growth of that aggregate in line with demand (the product of real demand and the targeted price level) over the medium and the long run.

That task could be fulfilled via the control of monetary base, so long as a stable relationship could be demonstrated between this and the chosen wider monetary aggregate (another test for the scientist). With no big gap between the growth in supply and demand for that aggregate, money should not get out of control and the feared monkey wrench would remain locked up. The monetarists in general did not contemplate what damage the monkey wrench might do (if not locked up) in terms of malinvestment and asset price inflation. Their focus was on goods and services inflation and its potential ill effects.

In practice, monetarism has long since withered away. The US experiment in applying this doctrine was particularly short (1979–82). Under actual institutional arrangements, the authorities had considerable difficulty in

determining exogenously the supply of a broad or semi-broad money aggregate with any precision at all (the Bundesbank came closest by utilising high reserve requirements on banks). In any case, earlier empirically determined stable demand functions for the chosen monetary aggregate often proved to be erroneous.

Yes, the supply of monetary base (the narrowest aggregate) is completely under the control of the authorities in a fiat money regime. But the demand for monetary base, under post-1914 monetary regimes in the US and abroad, even before considering the radical changes (in particular, QE and payment of market interest on reserves) of the past two decades, has been far from broad or stable or easily estimated, even over long-run periods. The problem here has been that the components of the monetary base under modern fiat money regimes—deposits of the banks at the central bank and cash—have many close substitutes (for example Treasury bills, instant non-penal credit facilities at the central bank, payment and credit cards which the holder can use to transact at the same retail prices as users of cash). They are not in effect high-powered money except in name. Small changes in interest rates, rate spreads and fees can induce big shifts in demand for monetary base. By contrast, under a regime where the monetary base includes mainly instruments with a distinctive high "moneyness", as would be the case for gold coin, gold bars and banks' holdings of reserves as aggregated across countries on a gold standard, demand for monetary base is firmly related to income and wealth.

In principle, there are two exits from the disillusions of monetarism.

The first is to move forward along the road to sound money, learning where appropriate from past errors including those of the monetarists.

Progress would consist of eliminating the government (and central bank) manipulators of interest rates and constructing a monetary system based around a strong anchor. Price level and inflation targets would be scrapped in favour of automatic monetary mechanisms (operating in effect to set upper and lower bounds to monetary base expansion), which should mean a very long-run tendency for prices of goods and services on average to revert to the mean (moving down or up for sustained periods in the medium term). This mean is not absolutely fixed nor totally pre-determined.

The biggest challenge for the sound monetary system architects would be the designing of a monetary base. It is important that there should be a broad and stable demand for this aggregate. That requires structural reforms in the sense of curtailing radically "too big to fail" (whereby systemically important banks in effect have access to government bail outs), deposit insurance, credit and payment card oligopolies (which try to prevent retailers passing on interchange and other fees to card users), and other barriers to cash circulation (e.g. small upper limits to size of banknote denomination). All these reforms together would powerfully bolster and broaden the demand for monetary base.

The second exit from the failure of monetarism is to abandon the quest for sound money and instead install top macro-economic managers in the monetary administration (via the central bank) whose stated aims would be high employment and stable prices.

The tools at the disposal of these managers would be designed to manipulate interest rates along a path mapped out by powerful econometric models. They do not use the monetary base as a control mechanism, though in principle they determine its size. They would not return to the practice of the Federal Reserve at times between 1920 and the mid-1980s in cross-checking that their chosen path for short-term money market rates results in the monetary base cumulatively staying within a target or quasi-target range. (The cross-check in the 1920s and 1960s occurred in the context of whole and then partial convertibility of the dollar into gold; growth in the fiat component of monetary base as consistent with the Fed's chosen rate path could bring into question whether gold reserves were sufficient and trigger a tightening of policy.)

The managers would also have "emergency access" to a bag of unconventional tools to be deployed towards reaching their aims. The monetary administration, headed by political appointees, is a part of government, albeit with some weak outward semblance of independence. A key unstated part of the monetary administration's purpose is the levying of monetary repression tax and inflation tax; their success in this is very important in terms of their relationship with government.

US Hegemon Leads World Down Unsound Path

The US as monetary hegemon led the world along a deeply flawed path out of monetarism.

Stanley Fischer (1977) amongst others was at the forefront of the academic assault on monetarism and advocated enlightened central bank economic management based on the power of modern econometrics. Later, these economists demonstrated great skills in the corridors of monetary power, scaling the ladder to become top monetary bureaucrats and advisors to Presidents, who saw the potential for neo-Keynesian engineering to win a second term at the next election (and after that le déluge, possibly, but who cares).

Before this ascent of the neo-Keynesians, dollar devaluation policy had resumed in the second Reagan Administration. In early autumn 1985, Fed Chief Volcker joined with Treasury Secretary James Baker in implementing the Plaza Accord. The turbulence this produced on the European currency scene—including a new revaluation of the Deutsche mark—played a big role in powering the train towards European Monetary Union (see James 2012).

Through the 1990s, after the global asset price deflations and recessions of 1989–92, the Federal Reserve having totally abandoned the last vestiges of monetary rules with respect to monetary aggregates (broad or narrow) and focusing under Alan Greenspan on masterly piloting of short-term interest rates, gained acclaim for the so-called Great Moderation. The NASDAQ crash and apparent mini recession of 2001/2 blemished that record, such that in 2002/3 President George W. Bush, facing difficult elections in 2004, resolved to use the power of appointment to guide the Fed on to a "pro-growth course".

Accordingly, President Bush appointed renowned "inflationist" and neo Keynesian Professor Ben Bernanke (a disciple of Stanley Fischer) as a Fed Governor (then fast-tracking him into the "Economic Cabinet" in preparation for the top Fed post), and meanwhile extended Greenspan's tenure for a half-term—all in the implicit expectation (no evidence of any direct negotiation on this) that policy would be "stimulatory" in the run-up to the 2004 elections. The "breathing in of inflation" on the basis that this was too low at around 1% became a milestone in the development of the 2% inflation standard and in Europe similarly we had the famous press conference of the ECB's eminence grise, ex-Bundesbanker Otmar Issing, in early 2003.

The payment of market interest rates on monetary base (authorized by Congress in autumn 2008) and successive bouts of quantitative easing (QE) dealt the final coup de grace to any residual ailing anchor to the US monetary system. The demand for monetary base became so unstable and indeed unknowable that it could not possibly function as anchor. All of this was a far cry from the norm of Fed practice through most of its prior existence, at least until the early 1990s, where in setting the interest rate path, it accepted that the growth of monetary base in some loose fashion constrained its freedom of action.

Counterfactually, what would have been the sound money way out of the flaws of monetarism? Short answer: to reconstruct the monetary regime in a way which would ensure a strong and resilient anchor to the monetary system such that the principles of sound money could triumph.

A longer answer starts with a look at what we should learn from the flaws of monetarism.

Prices Are Not Stable Under Sound Money

We have already considered the problems in applying monetarism due to no stable demand and exogenously determined supply for wide or semi-wide money aggregates. But there is a deeper issue. Even if the holy grail of such an aggregate and its supply conditions could have been found, would all have ended happily under monetarism?

Most likely not: for prices do not follow a smooth monotonic path under a sound money regime. Yet that is the implicit standard of success for the monetarists, albeit that Friedman cautioned against making the price level the target of monetary policy. He argued that the central bank should be judged by what it can control, the money supply, not prices. The latter, over the short term at least, are influenced by factors outside the central bank's control. Even so, Friedman embraced the idea that the authorities, in setting the money supply target, should acknowledge the aim of stable prices over the medium and long run. The sound money critic would say that "medium and long run" should have been replaced by "very long run" and in the sense of a tendency for prices to revert to the mean (which could shift through time).

We should mention here a key insight of Austrian School economics—the existence of a natural rhythm to prices (upwards, downwards, and sideways) for goods and services. Multi-year bouts in productivity growth or in the momentum of globalization—or acceleration of technological change or a sudden abundance of key natural resources—can go along with a sustained natural rhythm downward of prices and conversely.

Big changes in the structure of the labour market, even if not accompanied by a bout of positive or negative productivity growth, can set wages and prices in a downward or upward direction for some considerable time. For example, if the bargaining power of labour is declining (as may be the case where technological change is favouring monopoly creation and reducing simultaneously the scope of restrictive practices or unions to influence pay rates in some sectors), then wages could drift down on average until a lower level is reached consistent with the new balance of forces in the labour market. An additional factor here (to bargaining power) can be the waxing or waning of scope for types of labour to earn rental income with respect to specific qualities, perhaps because these become obsolete and new employment growth is in highly standardized jobs.

The business cycle itself is a source of natural rhythm—downward pressure on prices to a low level during the weak phase and upward pressure to a higher level during the expansion phase. This pro-cyclical move of prices is a key mechanism in economic recoveries as the expectation of higher prices eventually incentivizes some businesses and households to bring forward spending into the weak phase (see Brown 2017).

A sound money regime should not interfere with this natural rhythm except in the sense that in the very long run movement or prices up or down is bounded (by the operation of the regime) with some tendency for a regression towards the mean. Any monetary regime—including monetarist—which tended to fight the natural rhythm, producing a smooth outcome for nominal economic variables, whether "price level" or "incomes", would inflict much damage.

The pre-1914 gold standard regime, where in effect the monetary base for the total gold area (all countries with gold monies) was made up primarily of above-the-ground gold, fully allowed such price fluctuations to occur upwards and downwards. Fighting the natural rhythm of prices did not occur under gold; instead velocity of base money fluctuated considerably in the short and the medium term. The struggle under fiat money regimes to stabilize the "price level" or "low inflation" has induced serious problems under the heading of asset inflation and malinvestment.

No one estimated a demand function for monetary base under the classical gold standard, where this function would have included principally real income and prices and interest rates, fitted against say monthly or quarterly observations. The success of gold and gold monetary base as the anchor depended on a long-run stability in demand for gold. That should be the model for ersatz gold monetary systems.

The extent to which monetarism set out to be an ersatz gold system, at least in one country, is debatable. Sceptics on that hypothesis can point out that the natural rhythm of prices, intrinsic to sound money regimes including the gold standard, is not a concept found in monetarism.

Crucial Evidence from the 1920s

As a historical example, Milton Friedman and Anna Schwartz describe the years 1922–8 as the high tide of the Federal Reserve (see Friedman and Schwartz 1963). The narrow money supply was growing at a steady low rate in line with their estimated demand for real money balances. Prices were stable.

Yet, for the Austrian school economists this was a period of huge monetary inflation.

Rapid productivity growth was putting serious downward pressure on prices (and simultaneously there was a growing glut of commodities). Under a classical gold standard, monetary forces would not have resisted price declines in the short run even though empirical estimates might have shown supply of narrow money in excess of demand (given the boost to this aggregate in real terms from the fall in prices which could outweigh the fillip to demand from a trend rise in real incomes).

Nothing to worry about here: individuals' holdings of narrow money are not being continuously re-balanced. There is quite a lot of slack over short and medium-term periods around whether they are holding the "right amount of money" given the value of the variables assumed to determine their optimal holdings. Over the long run, slack in both directions tends to diminish

Over the longer term, monetary forces would put some upward pressure on prices from their low level (relative to historic mean). These would emanate from an increased supply of newly mined gold (spurred by fall in cost of production). But that could work itself out over many years. So initially the observed velocity of narrow money would fall below the long-run average and empirical estimates, but then it would rise back again. The stability of monetary velocity and prices which Friedman observed reflected direct stimulus from activist interest rate policy. The Fed's tampering with the supply path of monetary base, boosting this in various key episodes (most famously in 1927 when Governor Strong came to the help of the Bank of England and simultaneously gave a boost to Wall Street) made that activism possible over a sustained period of time.

Missing from the monetarist analysis of the 1920s amidst the acclaim of the Fed for having successfully steered money supply in line with real demand is this new key element of "interest rate policy" which the Fed introduced into policy making.

Under the pre-1914 international gold standard, interest rate policy did not exist (unless we interpret this to include crisis rate adjustments to stem flows of gold). Short-term rates there were determined by supply and demand for monetary base (in gold); local shortages or gluts of monetary base could occur, symptomized by sometimes wide spreads between local and foreign money rates (albeit all monies on gold) related to a whole range of factors, but these would be relieved by gold shipments (but whilst they lasted there could be spreads sometimes wide between different centres). Under a deeply corrupted and no longer global gold standard, the newly created Fed from 1919 onwards explicitly set interest rates in short-term markets with a view to influencing overall economic conditions in some way. It deliberately on occasion administered boosts to the supply of monetary base on a totally discretionary basis, flaunting the automatic control system central to sound money, specifically towards helping the UK authorities stabilize the pound or towards accelerating economic recovery or overcoming stock market weakness. These injections of monetary base prevented the path of this aggregate from getting in the way of the Fed's interest rate policy (even though the time of the injection did not coincide with an actual clash).

The Fallacies of Interest Rate Policy

For any given path of monetary base there is a corresponding path of money market rates. But once the Fed (or any other central bank) gives prime place to interest rate policy, the monetary base path becomes the dependent variable (albeit still under the control of the central bank but via the indirect route of setting the money market interest rate path). Dependence is constrained