Fix the Economy: End the Fed
Guest: Hunter Lewis
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Hunter Lewis is the author of numerous books, including* Where Keynes Went Wrong*.

WOODS: I want to start off with something that is a little bit more mundane, and that is the general question of how the Fed actually enables government growth. I think a lot of people, liberty people, believe that it does. But if you ask them for the precise mechanism by which the Fed does this, I think they'd have a hard time explaining it.

LEWIS: Yes, the Fed is financing the growth of government today, and government could not grow as it has without the Fed's financing. As the government goes further and further into the economy, taking over one sector after another, all that costs money. It's financed to some degree by taxes, of course. It is financed to some degree by borrowing abroad from the Chinese and the Japanese. But at the moment it's financed even more by the Fed's simply creating money and making that available to the government.

Now, of course, it's a very indirect process by which the money's made available to the government. In fact, one of the things that, of course, people don't understand is that in 2008, when the Fed rescued Wall Street, it was also rescuing the U.S. government. The government issues the bond. Wall Street buys the bond. Then the Fed buys the bond back. So in effect, it's as if the government had sold the bond to itself, i.e., the Fed. But it's indirect, because it's illegal for the government to directly sell a bond to the Fed.

WOODS: Do you think there's any reason it is so indirect, other than this makes it more complicated and therefore more difficult for the public to figure out what's really going on?

LEWIS: Well, that is a major motivation. When some of these techniques were first developed in the 1920s and the 1930s, one of the great advantages in the view of monetary authorities was that it could all be done secretly behind closed doors, and nobody would have a clue what's going on. But, it's also true that the Fed statute does not permit the Fed to directly buy bonds.

WOODS: That's my poinT. Why did they write the statute that way? I think it's to throw people off. Once you get investment banks involved, people's eyes glaze over. They don't understand what's going on. Whereas if the government directly had a printing press, then it would be, I think, much clearer to the public what's happening. That brings me to the first section of your book *Free Prices Now! Fixing the Economy By Abolishing the Fed*. I think it's very interesting the way you've organized it, beginning with a discussion of the price system and the importance of the price system, and then you going on to explain how this is relevant to understanding the damage that the Fed does.

So can you explain the connection? Why did you organize the book this way? I think it's an interesting and compelling way to do it. Why did you do it?

LEWIS: Well, I think the first thing that everybody has to understand is how critical free prices are to an economy. They make it work. Consumers depend on honest prices, investors depend on honest prices. I mean, how can you make a sound decision without knowing what's going on? And honest prices tell you what's going on. So that's just essential. I mean, why is it that the Soviet Union eventually collapsed? It collapsed because it would not allow honest prices. And there was no way that it could function that way, so it was just a matter of time before it would collapse. So for some reason, we have increasingly introduced in the United States some of these same techniques of manipulating and influencing, controlling prices, that never work and that only destroy an economy. So that's the first point to be made. Then, of course, who is the biggest price-fixer in the economy? It is the Federal Reserve. It is the monetary authority, because they're fixing the cost of credit, which is one of the biggest prices we have.

WOODS: So what I think you're doing here, which is, as I say, quite clever, is more or less saying to people, here's economics 101 about how prices work. This is what any undergraduate would be taught about the role of prices. But we're taught to be schizophrenic in economics. Yes, we just taught you about the need for free prices. Now, on the other hand, here's the Federal Reserve, and it's indispensable. But wait a minute. What about what you just taught me about free prices? And it's like you're supposed to have two heads, two brains working simultaneously.

LEWIS: Well, of course the Fed does not acknowledge that it's a price-controller. In fact, Ben Bernanke met with a group of college students in Washington a year or so ago, and he gave a lecture. Lo and behold, he talked about how important prices were and what an integral role they had in the economy. And he went on a bit of length on the subject. So it apparently never occurred to him that the Fed is fixing prices.

WOODS: And it's not even just interest rates that the Fed interferes with. It indirectly affects all kinds of prices, and that's of course part of what leads into the Austrian theory of the business cycle—is that it will lead to prices in some sectors going up faster than others. It will lead to false signals of profitability being sent to entrepreneurs, so it has an effect all through the economic system. And yet people will say that when there's an economic downturn, we need the Fed to give us the medicine that the economy needs. Yet you have two chapters here in *Free Prices Now* on how Dr. Fed makes the patients sicker. So you're saying that the problem is the medicine itself?

LEWIS: Yes. I remember back in 2009, I was talking to the BBC, and they said, "But Mr. Lewis, how can you suggest taking life support from the patient?" And I said, "No, I'm not taking life support from the patient. I'm just taking away the alcohol from the alcoholic or the morphine from the addict. That's quite different."

WOODS: Let me put it this way. It seems, superficially, that when you have an economic downturn it might be a good thing to create some money, inject some credit into the economy to try to get activity going again. You've got a lot of resources that are idle, factories that aren't being used, human beings who are idle who have talents that aren't being exploited—so it seems like it's like a pump. You just pump it up. Or it's like a crank that you turn, and it gets the system going again. What's wrong with these analogies?

LEWIS: Again, without honest prices, everybody is confused, and everybody makes bad decisions. John Stuart Mill, who was perhaps the most famous economist in the nineteenth century, outlined the problems more than 100 years ago. We've known this for a long time, and yet we keep making the same mistake, completely to sabotage the economy by destroying the price system on which the economy depends. Why is it that after thousands of years in which the human race made no progress economically, there was absolutely no economic growth, we finally started to have some economic growth in the period that we call the Industrial Revolution? It's because there were reforms that enabled prices to be a bit freer that they had been before, and yet now were going the opposite direction of trying to fix and control prices even more.

WOODS: How do you apply this type of analysis to the housing bust and the financial crisis of 2008?

LEWIS: Well, it's the same thing. The primary cause of the dot-com bubble and then the housing bubble was too much money being printed by the Fed and other central banks. And of course, that money in the housing bubble, much of it went into housing. So of course that blew up the housing market. That made people working in the housing sector feel very good for a while until the bubble burst, and then they became unemployed. That brought millions of people into housing-related industrial work, where they eventually found that everything they had learned was useless, because they couldn't get any further work during the bust. It completely destabilized the economy in one way after another.

WOODS: What about the argument, though, that if we didn't have the Fed creating money, the natural tendency on the market would be for prices to fall and we need to counteract that? Because if we have price deflation this leads to all kinds of ancillary problems, the conventional wisdom goes.

LEWIS: Well, of course that's a complete fallacy. When the price of a computer comes down, and we get a better computer for less money, that's a good thing. And the people that it helps the most are the poor, because they have the least money, and the prices are going down, and that helps them. So we all ought to be aiming for gently declining prices produced by greater and greater economic productivity and better success. The other thing that is worth thinking about is that if we have an efficient part of the economy like computers, for example, where prices are declining, and if the Federal Reserve says we require that prices go up at least two percent a year, what kind of inflation is going to be needed in the less efficient parts of the economy to offset the price declines in the efficient part? You end up calculating that to get to a two percent overall inflation rate if prices are going down, say, three percent in the more efficient sector, you probably need seven percent inflation in the less efficient sectors. So when the Fed says we want at least two percent inflation, they're really saying we want seven percent or more in much of the economy.

WOODS: That's an interesting point. So, in other words, to offset the sectors of the economy that are efficient enough to have falling prices for there to be an average of two percent inflation, we need to overwhelm that, and in effect, what we're doing is propping up the less efficient sectors of the economy. What about, though, somebody who's said to you, "Look, Lewis, you pretty much got everything you want already." And by the way, I get this a lot. I get this a lot. People will say you have a free market. You have a free market in banking. Sure, they have to get a government charter or whatever, but we have completing banks, and they can establish whatever banking policy they want. So you have free banking. You have private property. So what's your gripe here? You're already living in the libertarian paradise.

LEWIS: Well, of course we don't have free banking at all. We don't have a free market in banking, and we haven't for years and years. There are no free prices in banking. Almost all prices in banking today are made-up prices. They're just made up by government regulations, controls, rules, agreements. In 2008, when we had the crash, the single precipitating factor above all was probably a new bank regulation called mark-to-market. On the surface, that sounded good. It was a regulation that banks needed to price their assets using market criteria. But of course it was nonsense, because there were no market prices in banking. It was impossible, and so it basically was just poking a big stick into the wheels of the system. Even a bigger stick than had already been poked in there, so the system went into arrest. It couldn't handle that, and in fact, the very month that the economy stopped crashing was when they finally tabled mark-to-market rules.

And of course, Ben Bernanke was one of the biggest proponents of the mark-to-market rules. I think Steve Forbes called mark-to-market rules, "Mark to make believe," but all of the banking prices are make-believe. And you remember that when we had the collapse in the mortgage market, and the government said, "We've got to get these bad mortgages out of banks," they developed this subsidy program where they went to Wall Street and said you buy the bad mortgages, and we'll basically provide the money. And we'll ensure that you make a profit. Wall Street didn't bite. They still wouldn't buy the mortgages. Why not? Because there were no valid mortgage prices. They had no idea what those mortgages were worth. There was no mortgage market.

WOODS: In *Free Prices Now* you do give us an idea of what kind of reform would be useful. So if I gave Hunter Lewis the keys to the whole system, and I said you could reform banking in any direction you want, and you can reform the monetary system likewise, what would you do?

LEWIS: Abolishing the Fed would be a good first step, and we have to remember that we didn't have a Federal Reserve for most of American history after Andrew Jackson succeeded in getting rid of the second central bank and the earlier one. Early in the nineteenth century we didn't have a central bank for many years, and the economy actually did better during that period of time. So that's a start. And then the other necessary reform to do something about banking is to return it to a free market, to no longer have it just be a stepchild of government, whose primary role is to help finance government through its borrowing, but instead to actually help the economy.

WOODS: How would things look then? For the average person to try to understand this, how would their lives be different? How would they notice a change in a Hunter Lewis society? What would their money consist of? What would it look like? Would it be gold and silver? Would it be paper? Who would be issuing it? How can you fill in some of the blanks for people who might be sympathetic but just have a hard time visualizing it?

LEWIS: First of all, what I'm concerned about is poor people and the middle class. They are the people who are absolutely taking it on the ear today. The middle class is collapsing. Their real incomes are collapsing. The poor have very few prospects of pulling themselves out of poverty because of the system, the way it's been run today. It's all favoring a group of people who are closely connected to the government that are getting richer and richer, while those people do so badly, so we really do need fundamental reforms. Now, what would money look like under a new system? The market would decide that. The market is perfectly capable of developing money just like any other product.

WOODS: Do you think there's a particular type of money that winds up victorious in free-market competition, or is this just a matter of having to wait and see?

LEWIS: Most likely it would have some link to gold. Perhaps it would be gold, because gold has thousands of years of history as a currency. And it's not something the government can just print at will, so it probably would have some gold basis. But it's better for the market to figure it out and to produce the best product just like in any other field.

WOODS: You wrote an earlier book called *Where Keynes Went Wrong.* In our closing minutes, can you pinpoint what you consider the one central fallacy that you think drives the whole Keynesian system?

LEWIS: Well, yes. These Keynesian fallacies are driving the system. They're driving economic policies around the world, and let's just start with this one. First point from Keynes is too much debt causes a crash. Load on more debt. Secondly, taking on more debt will help reduce debt. These are all paradoxes which defy common sense, which in fact have no factual or logical basis. Of course another good one is borrowing and spending rather than saving to create prosperity. We all know that borrowing and spending is a way to go bankrupt, not to create prosperity. And yet, national policy is based on it today.

WOODS: Because there's been this revival of Keynesianism after the financial crisis, there are Keynesian preconceptions all over the media and all over the national discussion of economic questions. So the discussion always winds up being what type of stimulus should we have. Which is of course the wrong question.

LEWIS: Yes, and the other thing that I find very interesting is that the leading Keynesians—someone, for example, like Shiller, who just got to know a little economics yesterday—that none of them ever offer a defense of Keynesian doctrine. They don't explain the factual basis for it or a logical basis for it. They just assume that it is correct, and they assume that anybody that challenges it is a crank. Not only do they assume that it's correct without any proper defense of it, but they're always so imprecise about what they recommend. They say they want more stimulus, or they want more money printed or whatever. They never say how much deficit spending or how much money printing. It's all very vague.

WOODS: I know this is not covered in your book, but I can't help asking just because it's come up a little bit in the news recently. There's been talk about government default, and we all know there isn't going to be any government default. This is just political theater as always. But there have been Austrians who have suggested that there is a good economic or at the very least moral case for in fact defaulting on government debt. Where do you come down on that?

LEWIS: We have to remember that as Jim Grant pointed out in a *Wall Street Journal* piece recently, we're already defaulting. First of all, the U.S. government has defaulted in fact at earlier times in U.S. history. But what we’re doing right now is just a stealth default in which you borrow money, and you pay back money that buys less in the future. So we’re already defaulting, and we seem to be on a path in which we’re going to default more and more but as stealthily as possible so that it is isn’t obvious that we are defaulting while we are.