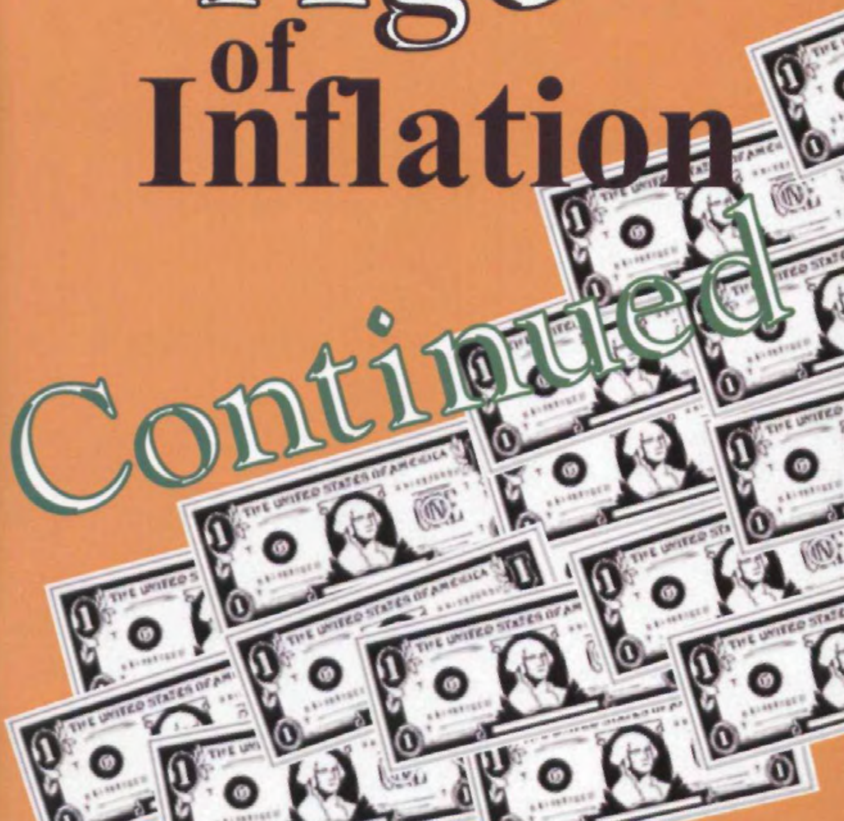
Age of Inflation Continued



Hans F. Sennholz

In 1978, when the last pages of Age of Inflation were penned, the annual inflation rate was on the rise. It peaked in 1980 at 13.58%, before declining to a low in 1998 of 1.55%. Today, inflation is on the rise again, but this time, the U.S. has new problems as the world's largest debtor. A new generation must cope with the ageless problem called inflation. The answers are different from those that worked during the early 1980's. To understand today's problems and solutions, see Age of Inflation Continued.

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Inflation Without End

In 1978, when the last pages of Age of Inflation were penned, President Jimmy Carter was haggling and wrangling with Congressional leaders about vexatious economic issues. Consumer prices, which had risen 6.8 percent in 1977, were climbing at an ever faster rate. In a televised address to the nation, the President bravely addressed the problem: "It is time for all of us to make a greater and more coordinated effort." He called for workers to limit wage increases to 7 percent and asked companies to hold price increases below those of 1976 and 1977. Yet the dollar continued to decline. The President then announced a number of federal actions including massive U.S. intervention in foreign exchange markets to bolster the dollar. The fall of the dollar nevertheless accelerated; its purchasing power shrank 7.62 percent in 1978, 11.22 percent in 1979, and 13.58 percent in 1980.

This was not the dawn of the age of inflation. Some economists point to World War I, when nearly every country in the world took recourse to nonconvertible paper money. For a few years after the war, the standard was restored, although gold coins were no longer in circulation in most countries. It was abolished again during the great depression, by the United Kingdom in 1931, the United States in 1933, and most European countries in 1936. Soon thereafter, not a single country observed the gold standard.

A few American economists hint at the inauguration of the Federal Reserve System as the beginning of the age of inflation. The System was established by law in 1913 and began to operate in November 1914. Its primary functions ever since relate to the maintenance of monetary and credit conditions favorable to business activity in all fields. Its primary duties are lending its funds, which it may create, and setting discount rates, which it is free to manipulate. The dollar, which it has studiously managed toward those ends, unfortunately has lost more than 91 percent of its purchasing power in 91 years of Federal Reserve existence.

Other economists look upon the launching of President Kennedy's "New Frontier" and President Johnson's "Great Society" as the dawn of the age of inflation. President Kennedy embarked upon massive spending programs of federal aid to education, medical care for the aged, aid to depressed areas, and an accelerated space program. President Johnson soon thereafter launched his "War on Poverty" with a Job Corps, Opportunity Head Start, Volunteers in the Service to America (VISTA), Medicaid, and Medicare. The costs of these programs were made to accelerate year after year—just like the costs of the Vietnam War which President Johnson was waging. The Federal Reserve System readily accommodated both federal courses of action with generous issuances of money and credit. During the 1960s, it made the U.S. dollar lose some 21 percent of its purchasing power. The losses thereafter accelerated to 55 percent during the 1970s, 44 percent during the 1980s, 26 percent during the 1990s, and some 15 percent so far in this decade. Relative to 1960 purchasing power, the U. S. dollar has become an anemic currency, presently worth barely a dime. Surely, inflation is gnawing at every U.S. dollar without reprieve or end in sight.

Some economists who define inflation in an old-fashioned way point to the stock of money created or managed by the Federal Reserve System.

U.S. Stock of Money

(in billions of dollars)

	Federal Reserve currency	Ml F.R. currency commercial bank demand deposits	M3 F.R. currency demand deposits savings accounts time deposits
1960	28.8	140.0	301.5
1970	46.0	206.2	618.3
1980	106.0	385.8	1826.4
1990	223.9	795.3	4091.7
2000	525.0	1121.6	6630.5
2005	718.7	1368.9	6680.5

Source: federalreserve.gov/releases

Academic economists who like to search for thoughts, notions, and concepts that gave birth to the age of inflation point to prominent thought leaders and authors who paved the way. The pathfinder of them all undoubtedly was John Maynard Keynes, whose ideas, based on large-scale government economic planning, are best expressed in his work, The General Theory of Employment, Interest, and Money (1936). Some economists who faithfully followed in his footsteps were A. H. Hansen, R. F. Harrod, P. A. Samuelson, A. P. Lerner, Joan Robinson, W. Beveridge, to name but a few. Some writers such as O. Lange and P.M. Sweezy even added a measure of Marxian thought in support of their spending plans and programs. All these writers and many more were the architects and framers of the policies which legislators and regulators have been conducting faithfully and fervently ever since.

Their preponderance in all matters of political and economic thought has convinced us that the U.S. dollar will continue to depreciate in the foreseeable future. Some financial analysts are warning of much higher inflation rates to come, but many believe that the rates will remain relatively low despite soaring energy prices. They are persuaded that high energy prices force many consumers to cut back in other purchases which keeps the core rate of dollar depreciation near two percent. In reality, consumers can be expected to react in different ways to rising energy prices. Many may be able to reduce their consumption of energy, others who cannot cut back may curtail other consumption. Others yet may simply bear the higher costs. Most people react directly to price changes they anticipate. They first may cut back their purchases when they expect goods prices to decline, which would enable them to buy more in the future. They may hasten to purchase when they expect future prices to soar. As the rate of Federal Reserve monetary expansion varies frequently, we must brace for reactive consumer cutbacks followed by rushes and surges, in an unending sequel of stops and goes.

Mainstream economists and financial analysts usually cite several more reasons why inflation will not soar and why the dollar will maintain its position as the world's primary reserve currency. They point to the Federal Reserve's boosts of its discount rate to a level that is said to approach the market rate at which member banks are discouraged from borrowing more Federal Reserve funds. But we doubt that the present discount rate of 4 1/4 percent is even close to the unimpeded market rate. Goods prices presently are rising at 3 to 4 percent, which reduces the net interest rate to 1/4 to 1 1/4 percent. Moreover, even if this were the free market rate, it would not immediately affect the power of commercial banks to continue their fiduciary expansion. After all, they are loaded with mountains of excess reserves which the Federal Reserve has so generously provided in the past. They can continue to expand their credits at multiple rates. At a five percent reserve requirement, a one-million dollar excess reserve allows a bank to extend twenty million dollars in new credits. Of course, it would always have to be careful not to expand its credits faster than its actual reserves allow.

All over the globe, trade barriers have come down ever since the disintegration of the Soviet empire and release of its satellites. Many countries now are adjusting to world market conditions and allowing foreign products and services to enter and compete. Computers, software, and cell phones now are boosting productivity in remote places, which are advancing from a horse-and-buggy age to a computer age. Free trade and modern technology are raising labor productivity and increasing world competition, which is keeping a lid on world market prices. It especially thwarts and frustrates unionized industries which depend on legal protection and immunities. All such changes have persuaded mainstream economists and analysts that this "global war on inflation" has succeeded in eliminating the "inflationary psychology" of companies around the world. Producers everywhere, they are convinced, have learned to boost efficiency and productivity rather than to simply raise prices.

We readily agree with such observations, but disagree with the conclusions. Removal of many trade barriers since the disintegration of the Soviet empire has increased economic productivity and improved living conditions in many parts of the world. Consumer goods from China, India, and many other poor countries are competing effectively with U.S.-made products and restraining most prices, but they do not weaken or even repudiate the inflation ideology; in fact, alleviation of inflation effects may encourage and reinforce inflation proper. It may induce the U.S. government to continue to incur huge budget deficits, increase its debt by the trillions, and prompt the Federal Reserve to facilitate it all.

The U.S. dollar continues to function as the world's best-known medium of exchange. Yet, we are rather fearful that foreign central banks, which are holding large piles of U.S. dollars, may some day dump some dollars to avoid ever larger losses. We do not know the foreign creditors who will lead the way and do not know when and why in particular they will unload their dollars. We cannot tell what the future will bring, but we do know that the present monetary order is inept and anomalous and, therefore, cannot last. It is bound to change, either gradually or abruptly, either tomorrow, next year, or a decade from now.

The future may be uncertain, but several potential scenarios come to mind. The optimists in our midst, living for something better to come, are hopeful that the federal government may soon learn to live within its means, that it will balance its budget and begin to reduce its $8 trillion debt. But such optimism is rather unrealistic; public opinion soon would take a stand against spending reductions, many of which would be entitlement reductions. No matter who resides in the White House or what political party controls the Congress, most entitlements are beyond the reach of review and, therefore, will continue regardless of revenue and debt. In public life, instead of frugality and economy, spending and dealing tend to hold sway.

Some optimists are confident that the Federal Reserve System may check its expansion of currency and credit, which soon would force member banks to cease and desist from their distention. But such happy expectation is even more unrealistic and fanciful than the hope of a balanced government budget. Federal Reserve inactivity surely would allow the American economy to readjust to actual market conditions; interest rates would rise until the demand for funds and their supply would be equal, leading to a readjustment recession with slumping production and rising unemployment. As the federal government is unlikely to reduce its spending during a recession, huge federal deficits would cause interest rates to soar to double-digit levels and further depress economic activity. Once again, the Federal Reserve would have to come to the rescue by slashing interest rates and expanding the stock of money. All along, public opinion would smile upon benefit spending, condone budget deficits, and acclaim the Federal Reserve for its valiant fight against recession and unemployment.

Some economists envision continuation of present monetary policies with the U.S. dollar depreciating at a rate of two to four percent. The Federal Reserve, we are told, is giving the country a measure of stability and pointing the way to economic growth and prosperity throughout the world. But these partisans blithely overlook the huge federal government deficits, as well as the massive trade deficits which render the American economy rather vulnerable. American savings are at a record low and current-account deficits are at a record high, which have ignited a global housing boom, the biggest financial bubble in history. A world economy so maladjusted is dangerously vulnerable to painful readjustment.

The economic situation presently looks ominously like the 1970s, when inflation soared at double-digit rates. Surely, the present bubble will burst, as all such bubbles did inexorably in the past, but what will it do to the economy? With price inflation edging up already, will the Fed slash its interest rates, as it did in 2001-2002, and thereby accelerate the dollar depreciation? And how will the federal government react? With present budget deficits at record highs, will it double the highs and reach six hundred or even seven hundred billion dollars a year? We had better prepare for one or the other, soaring inflation or a nasty slump.

The worst conceivable scenario would be a combination of present monetary and fiscal policies together with growth of American protectionism. The federal government may regulate imports and exports with the purpose of shielding domestic industries from foreign competition. It may exclude certain imports entirely, establish import quotas, or impose special duties on imports, thereby increasing the price of the imported article. Such measures undoubtedly would be popular with many domestic industries but highly contentious in creditor countries. For a debtor to strike at his creditors always is ill-advised and unwise; it could spell the end of the world dollar standard. Indeed, a mountain of debt casts a shadow on the brightest place.

The Dollar Standard

We may not be able to see the future, but we can always learn from the past. A cursory look at the history of international monetary systems may reveal where we were, where we are, and where we are heading. Ever since the dawn of civilization, precious metals have had wide monetary use, due to their convenience of handling, durability, divisibility, and their high value as jewelry. During the Middle Ages, European countries strove toward bimetallism, that is, the use of gold and silver as the monetary standard of value. The United States government adopted a bimetallic standard at its very beginning and clung to it throughout most of the 19th century. England was the first country that made gold the standard currency in 1798 and 1816; many countries hesitantly followed suit, the United States in 1900. Under this system, gold became the standard of value throughout the commercial world, furnishing a price denominator for all goods and services. Gold coins passed freely from hand to hand in full payment for economic goods and in discharge of indebtedness. They had no regional or national limitation, being accepted and traded all over the globe.

The age of the classical gold standard was rather short; it came to an abrupt end in 1914 when World War I erupted in Europe. The belligerent governments immediately revoked their redemption obligations, enabling them to issue money freely and generously. After the war, while the vanquished countries continued to inflate their currencies at accelerating rates until they became practically worthless, the victors soon replaced the coin standard with a bullion standard which used gold in the form of bars and ingots in international payment. The Great Depression soon smothered this system with massive budget deficits and numerous regulations and controls.

At the Bretton Woods international conference in 1944, the representatives of allied nations tried to restore monetary order by creating yet another system, the gold-exchange standard. The member countries fixed the value of their currencies not to gold, but to some foreign exchange, which in turn was redeemable in gold at a given ratio. Most governments fixed their currencies to the U.S. dollar and retained dollar reserves in the United States. In fact, they created an incipient dollar standard resting on gold. It served satisfactorily during the 1950s, facilitating numerous readjustments to the dollar, but came under severe pressure during the 1960s when President Johnson introduced his Great Society and waged war in Vietnam. Massive budget deficits, which the Federal Reserve readily facilitated, soon weakened international confidence in the integrity of the dollar, which led some dollar-holding countries to seek exchange of their dollars for gold. With the specter of U.S. international insolvency coming in sight, and in order to avoid the unthinkable, the U.S. government, in 1968, introduced a two-tier system, which limited payment of gold to foreign central banks at $35 an ounce, but denied gold payment to all others. And in support of the waning U.S. gold reserves, the International Monetary Fund created Special Drawing Rights as a new currency reserve. Despite all such measures, the drain on U.S. gold reserves continued.

The year 1971 was to be a landmark in monetary history. On August 15, the United States government removed gold as the foundation stone of the international monetary order and rescinded the international agreements that had defined the system since the end of World War II. In a nationally televised address, President Nixon simply announced that the United States would no longer honor its 26-year-old commitment to pay international obligations in gold at the rate of $35 an ounce. He imposed a 10 percent surcharge on imports into the United States and, above all, ordered virtually all wages and prices to freeze. Violators would be fined, imprisoned, or both. When the controls created frustrating problems, they underwent four "phases" of adjustment to "problem areas" such as food, health care, and construction.

The new fiat-dollar standard was a germane derivative of the Bretton Woods order, without its limitations. Liberated at last from any gold reserve requirement, it promised to serve all political needs. Unfortunately, it proved to be even less stable than its harbinger, more inflationary and, above all, more divisive and injurious to American prosperity and prestige.

Withdrawal of American troops from Vietnam in 1972 and 1973 did not end the price and wage spirals that were to mark the presidencies of Messrs Nixon, Ford, and Carter. With the federal government incurring massive budget deficits, the Federal Reserve duly supplied funds at single-digit interest rates, bank credit expanded at double-digit rates, and goods prices soared. The Fed occasionally would "tighten" its reins, but its rates always remained below market rates, often even below the rates of inflation. U.S. trade deficits increased erratically with dollar funds flowing to Western Europe and Japan, but the monetary authorities in Europe and Japan liked the exchange rates and defended them with substantial purchases of dollars. Their dollar support meant to sustain their own exports and to bolster and subsidize their own export industries. The abundance of dollar funds in central banks throughout the world then facilitated an explosive growth of money and credit in most industrial countries.

In 1974 and 1975, the fever of double-digit inflation was briefly eclipsed by the chills of recession. American unemployment rose to 8.3 percent, a 33-year-high nationally, and much higher in construction and manufacturing. It remained high although the chills of recession soon gave way again to the fever of inflation. Money and credit were made to expand again at double-digit rates, trade deficits set new records, and the U.S. dollar deteriorated further in international markets. By the end of the decade, the country fell again into the grip of the twin economic evils of recession and inflation. Unemployment rose again while GNP was falling. The Federal Reserve, under new management, finally meant to call a halt to the foment. It raised its discount rate to 12 percent, the prime rate rose above 15 percent, and the eurodollar rate to 20 percent. President Carter joined the campaign by imposing federal temperature controls in public and commercial buildings, setting minimum summer temperature at 78 degrees and maximum winter temperature at 65 degrees. Many Americans keenly felt the effects of gasoline rationing, waiting in long lines at gasoline service stations. Legislators and regulators had a ready explanation for the crisis: the sheikhs and emirs of OPEC had done it again.

In 1981, President Reagan took the helm of a deeply troubled country. During his eight years in office he managed to lift the spirits, changing the course, and relaxing the reins of government. He rolled back the Johnson Great Society but preserved the Roosevelt New Deal. He rejected Keynesian formulas for managing economic demand and instead followed "supply-side" prescriptions which aim to stimulate production and investment by way of tax reduction and removal of some government controls. Mostly at loggerheads with Congress, he insisted on rearming the country and confronting Soviet aspirations. He steadfastly resisted Congressional efforts to boost taxes significantly. With Congress raising social spending and the President expanding military outlays, Federal budget deficits soon exceeded two hundred billion dollars a year; the national debt doubled in seven years.

With the discount rate at 12 percent, the quantity of money and credit finally stabilized, allowing the economy to readjust to actual market conditions. A 25 percent Federal tax cut over three years brought some relief to business but tore big holes in the federal budget and capital market. The dollar regained some relative strength and the American economy became again the engine of the world economy. It slowed down after a spectacular Wall Street crash in 1987, which reflected the international concern about the budget deficits and the chronic trade and current account deficits of the United States. In ages past, the creditors would have demanded prompt payment in gold, which would have forced the debtor to mend his ways or face insolvency. The fiat dollar standard merely prompted contentious diplomatic exchanges—the creditors pressing the debtor to live within his means and the debtor urging his creditors to relax and stimulate their own economies with easier money, larger budget deficits, or both.

The decade of the 1990s was akin to the 1980s. It began with a recession, saw new acceleration followed by deceleration and a "soft landing" in 1995. Great concern about the large balance of payments deficits of the United States led to a sharp decline in the value of the U.S. dollar, especially versus the Japanese yen and the Deutsche mark, along with other European currencies closely tied to it. Coordinated intervention by foreign central banks was needed to stabilize the dollar. It rallied for a while when several Asian currencies foundered in 1997. Large current-account deficits led to sudden declines and devaluations of the Thai baht, the Malaysian ringgit, the Indonesian rupiah, the Philippine peso, the Singapore dollar, and the South Korean won. The International Monetary Fund (IMF), working in cooperation with industrial countries, kept the Asian crisis from spreading.

Throughout the 1990s, the Federal government suffered budget deficits, although political spokesmen frequently boasted of surpluses. In 1998, 1999, and 2000 the Clinton Administration waxed eloquent about its surpluses which, in time, would retire the national debt. In reality, the surpluses were deficits financed with Social Security money and other government trust funds. They increased the national debt with Social Security IOUs by as much as they did with Treasury bills, notes, and bonds sold to investors; payment obligations to Social Security beneficiaries are as binding as those to investors.

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Throughout the decades, a few economists were worried about the magnitude of the trade deficits and the vulnerability of the American dollar, but their fears proved to be unfounded because they underestimated the worldwide demand for dollars and the willingness of foreign investors and central bankers to trust and hold U.S. dollars. After all, until recently, the deficits never exceeded three percent of GDP and Americans still were net creditors in their foreign accounts. By now, in 2006, the dollar standard has reached a stage in which not only a few economists, but also some foreign creditors, are beginning to question its future. The Federal government is swimming in an ocean of debt. In its first term, the Bush administration increased the federal debt by $2.2 trillion. Congress raised the Treasury debt ceiling three times, by $450 billion in 2002, by $984 billion in 2003, and by another $800 billion on November 19, 2004, to $8,184 trillion. The ready willingness of Congress to finance such deficits is a clear indication of the political and ideological mold-and-make-up of most members of Congress, and the public that elects them.

Foreign observers are drawing similar conclusions. The Bank of Japan, which owns more than $800 billion in dollar obligations, already announced its reluctance to increase its holding. China, with dollar holdings exceeding $500 billion, is laboring under "unsustainable U.S. trade deficits." Asian banks, altogether holding more than $2 trillion in American obligations, are suffering hundred-billion dollar losses in terms of purchasing power. It is not surprising that the central banks of India and Russia, as well as some Middle East investors, have begun to sell dollar obligations.

According to some estimates, foreign banks and investors are holding some $9 trillion of U.S. paper assets. They are owning some 43 percent of U.S. Treasuries, 25 percent of American corporate bonds, and 12 percent of U.S. corporate equities. They obviously are suffering losses whenever the dollar falls against their respective currencies; even if they are pegged to the dollar, they are incurring losses against all other currencies that are rising.

The dollar standard surely would draw to a close if foreign dollar investors would panic and start selling their American paper investments—their U.S. Treasuries, U.S. agencies, and corporate bonds and shares. The crash would be felt around the world and neither foreign sellers nor American authorities could be trusted to react rationally in the fear and noise of the crash. The scene could be similar to the political bedlam of the 1930s.

There always is the hope that the primary creditors will act in concert and once again bail out the debtor. The European Central Bank, the Bank of Japan, the Bank of China, and the Bank of England may decide to avert the unthinkable and support the dollar by mopping up huge quantities. The mopping would stabilize the situation once again by inflating and depreciating their own currencies; they would pass the depreciation losses on to their own nationals. Optimists in our midst are hoping for this scenario; they are convinced that the Bush administration will in time save the situation by balancing its budget and the Federal Reserve will allow interest rates to seek market levels. Such a policy would avert the dollar dilemma, although it would lead to a painful recession forcing all economic factors to readjust to changing market conditions.

Pessimists in our midst cast doubt on such a scenario. They point not only to the host of legislators and regulators who cherish their position and power, but also to public opinion and ideology, which call for government favors. They are prepared to proceed on the present road and brace for the morrow. A few cynics even contend that a government facing a financial crisis of such magnitude is prone to divert public attention from its ominous path by embarking upon foreign adventures.

This economist is ever mindful that debts do not fade or pass away. Individuals must face them, deal with them, or renege in bankruptcy. Governments have an additional option: as the issuers of their own currencies, they may inflate and depreciate their debts away. The United States government has done this ever since it cast aside the gold standard and imposed the dollar standard. It undoubtedly will continue to do so as far as the eye can see. It proceeds on an iniquitous road which individuals would soon be barred from traveling, but governments love to take, shedding their debts one percent at a time. It is a road of the dollar standard designed at Bretton Woods, built by the U.S. government, managed by the Federal Reserve System, and financed largely by creditor central banks in Europe and Asia. It is a road on which the fall in dollar value has inflicted losses not only on all foreign dollar holders, each in proportion to the amount of dollars held, but also on virtually all Americans. It is the political road of debt default, the magnitude of which amounts to trillions of dollars, undoubtedly the largest in the history of international relations. It will be remembered for generations to come.

It is unlikely that the Federal government and the Federal Reserve will soon mend their ways, but it also is doubtful that foreign creditors will continue their support indefinitely. The U.S. dollar is bound to continue to depreciate and gradually surrender its role as the world's primary reserve currency to a multiple reserve-currency system resting on the euro, Japanese yen, Chinese renminbi, and the American dollar. The multiple-standard system is likely to perform more efficiently and equitably than the dollar standard. Competition would avoid the abuses and inequities of a monopolistic system. Confining the powers of the Federal Reserve System and constraining the deficit aptitude of the U.S. Treasury, it would ward off any further inundation of the world with U.S. dollars.

In idle reverie of years long past, this economist is tempted to compare the dollar standard with the gold standard. Throughout the short history of the gold standard, the balance of payments of gold-producing countries was usually "unfavorable." Since the birth of the dollar standard, the United States has assumed the position of the gold-producing countries; its balance of payments usually is unfavorable. Much capital and labor were spent to find, mine, refine, and market gold; the United States bears minuscule expense in the production of its money. The quantity of gold coming to market was limited by market forces; the quantity of dollars depends on the judgment of Federal Reserve governors who are appointed by the President. In times of turmoil and war, the quantity of gold mined declines; in such times the stock of fiat dollars tends to multiply and its value depreciates accordingly. The quantity of gold is limited by nature and its value is enhanced by many non-monetary uses; fiat and fiduciary moneys have no such uses or limitations. They are the sorry products of politics.

Deep in Debt, Deep in Danger

In a question-and-answer session conducted in September, 2004, a professor of economics responded to student questions about disturbing reports of excessive spending and dangerous levels of debt.

Student: The Federal government is about to reach the Congressional debt limit of $7.384 trillion. Should I be concerned about this debt? My history professor likes to quote President Franklin D. Roosevelt who once said: "Our national debt, after all, is an internal debt owed not only by the nation but to the nation. If our children have to pay interest on it, they will pay that interest to themselves."

Professor: In 1939, when President Roosevelt made that speech, the Federal debt may have been an internal debt, but it surely was not owed to ourselves. It divided the nation between people who enjoyed the benefits of spending, and their descendants, who were expected to square the account; it created a persistent social conflict. Since the 1980s, we have added a rapidly growing international debt. It is estimated at some $5.5 trillion, which amounts to one-half of our gross national product of some $11 trillion. Americans would have to labor half a year in order to pay it off. It is significant that our foreign creditors like to invest their dollar earnings in U.S. Treasury obligations, which enjoy the highest credit rating. They now own almost one-half of the Federal debt. The Bank of Japan is our biggest creditor, with some $700 billion in claims, followed by the Central Bank of China, with $ 165 billion. You need to be concerned because our rising international indebtedness endangers not only the position and value of the U.S. dollar, but also casts a dark shadow on world trade and commerce.

Student: The Congressional debt ceiling immediately raises a question. What can we expect when Treasury spending reaches the limit?

Professor: Indeed, Federal spending is likely to reach the Congressional ceiling by late September or early October 2005. This year's budget deficit may hit a record $445 billion which is $70 billion more than last year. If we add the amount borrowed from the Social Security Fund, the budget deficit actually amounts to $639 billion, or some 6 percent of gross national product. A tax increase of the magnitude required to balance spending with revenue would depress the economy immediately; a sudden cut in spending, which would launch a needed readjustment, would make much political noise. I doubt that the Republicans in both Houses want to pass legislation that cuts spending; it would affect their re-election hopes. They may rely on U.S. Treasury Secretary Snow to find ways that avoid embarrassment. In the footsteps of former secretaries Rubin and O'Neill, he may have to redefine the debt "subject to limit" or find new ways to circumvent the Congressional limitation.

Student: According to some economists, Federal deficits consume productive capital and lead to economic stagnation. What is your position?

Professor: I agree. A deficit is a shortage of funds not covered by tax revenues. I can think of four sources that may cover the shortfall: people's savings, foreign lending, Federal Reserve money creation, and credit expansion by financial institutions. Regarding people's savings, investors may buy

Treasury bills, notes, and bonds instead of corporate obligations. All three are certificates of savings consumed. Foreign lending may reduce foreign consumption and allow us to boost ours. When the debt falls due, the reverse holds true. Federal Reserve money creation debases the currency and causes economic upheavals; it creates economic maladjustments that waste much capital. Credit expansion by financial institutions has similar effects. The Federal government uses all four sources of revenue to cover its massive deficits. They all drain, dissipate, and waste productive capital. On August 26, 2004, the U.S. Census Bureau released an annual report according to which the number of Americans now living below the poverty line rose by 1.3 million in 2003 and now totals 35.8 million, that is, more than 12 percent of the population. No matter how you may define the poverty line, the numbers describe a state of economic stagnation for 35 million Americans.

Student: The same economists are concerned about the position and value of the U.S. dollar. How does international indebtedness affect the dollar?

Professor: Benjamin Franklin already answered this question in his Poor Richard's Almanac: "Creditors are a superstitious sect—great observers of set days and times." Our foreign creditors may soon raise the question of how long the U.S. can continue to enjoy huge trade deficits and make no visible effort to correct the imbalance. If they were to call this debt or merely disallow our current trade deficits of some $500 billion a year, interest rates would soar, equity markets would plummet, and the U.S. dollar would plunge. Its position as the primary reserve currency of the world would be severely impaired. In other words, as long as the world is accumulating American dollars and investing in dollar assets, it is sustaining the dollar. If it should unload some dollar holdings or merely decline to accept more, the dollar would face severe pressures in world money markets.

Student: You stated that almost one-half of our debt is held by foreigners. How did we incur this debt? I am not aware of any debt I owe to foreigners.

Professor: We incur debt to foreigners by way of trade deficits which are excesses of imports over exports. The dollars earned by foreign businessmen usually are deposited in foreign commercial banks which deposit them in their central banks, which invest them directly in U.S. Treasury obligations or other claims and assets in the U.S. Although you, personally, may not be indebted to foreign creditors, the money you spent on the shirt you are wearing may have gone to Hong Kong and come right back with many other dollars for the purchase of U.S. Treasury bills, notes, or bonds. They are certificates of debt.

Student: I don 't understand why we are suffering trade deficits.

Professor: You are not alone. Most Americans are at a loss about the mysteries of foreign trade and international relations. Some media celebrities and government officials are quick to point to foreign causes; others may wax eloquent about American affluence and the joy of spending and consuming. A few economists find primary fault with U.S. government policies, in particular the Federal Reserve policy of easy money and credit. They charge that Federal Reserve governors habitually ignore the market rate of interest at which the demand for loanable funds tends to match the supply. In order to stimulate economic activity, Fed governors like to keep their rates far below market rates, which causes the stock of money and credit to expand. Goods prices rise, which induces American businessmen to shop abroad and foreign buyers to reduce their purchases of American goods. Our trade deficits are the inevitable result of Federal Reserve monetary policies.

Student: Why don't we experience rates of price inflation higher than just two to three percent annually? Why instead do we suffer huge trade deficits that enable us to import and enjoy so many foreign goods?

Professor: If any other country would expand its money and credit at Federal Reserve rates, it would soon experience all the symptoms of serious inflation; its currency may lose much of its value. The American dollar differs from all others because of its size and position as the primary reserve currency of the world. Ever since the Nixon Administration discarded commodity money, that is, gold and silver, the U.S. dollar has filled the void and served as world money. It is used, invested, and hoarded all over the globe, which amounts to an extraordinary demand and support. Surely, the economic principles that rule the valuation of all forms and kinds of money apply also to the U.S. dollar. Given its size and position in the world, they work more slowly, but with equally inexorable force.

Student: Such an explanation is simple enough. Why is it ignored by countless media commentators and government officials alike?

Professor: It points the finger of responsibility and blame at them. They summarily reject any such explanation and continue on their merry ways. The officials enjoy loud acclaim and full-hearted public support as long as they conduct popular policies such as easy money and plentiful credit at bargain rates. They are unwittingly leading the way on a wrong path to currency depreciation and economic stagnation.

Student: Many other countries suffer higher rates of inflation than the U.S., yet they do not go deep into debt. On the contrary, as their money depreciates, they import less and export more. They become net creditors; their balance of trade becomes very "favorable."

Professor: Indeed, willful expansion of the stock of money by a central bank at first may cause goods prices to rise rather slowly, but as soon as people begin to expect ever more price inflation, they begin to reduce their cash holdings, that is, their demand for money declines, which causes the rise in prices to accelerate. When people finally despair about the shrinking value of their money, they may rush to exchange their holdings for available real goods. We then speak of a "flight from money"; for example, a ten percent expansion of the stock of money at first may cause goods prices to rise slowly at two, three, or even five percent. When people expect it to continue in the foreseeable future, prices may increase at double-digit rates. When people finally despair, prices may soar at triple-digit rates and the money may finally become utterly worthless. All along, the balance of trade becomes very "favorable."

Student: What is the payment record of governments in bygone times?

Professor: Governments rarely ever pay their debts in full. Throughout history, many simply defaulted when the burden of debt became bothersome; creditors are rather defenseless against debtors holding supreme political and legal power. Many monarchs engaged in open depreciation of their coinage, replacing precious metals with base metals and forcing them on their hapless subjects. In our age of fiat paper, governments merely issue ever larger volumes of their paper and pronounce it "legal tender." The increase naturally depreciates the money and diminishes the value of all debt. Since 1933, when the U.S. government repudiated its obligation to make payments in gold, the U.S. dollar has lost most of its purchasing power. By now, all creditors have lost various amounts depending on the rate of depreciation during the life of the debt. There cannot be any doubt that the present Federal debt of $7.384 trillion will suffer the common fate. At the present, it is depreciating at a modest rate of only three percent. In years to come, the rate is likely to increase and the debt to decline in value and purchasing power. It will dwindle and wane whenever the rate of depreciation exceeds the rate of debt increase. A ten percent annual depreciation will shrink the value of all debt substantially. After many years of such debt depreciation, when monetary calculation becomes ever more difficult because of enormous numbers, governments usually conduct "currency reforms." They suddenly decree an exchange of old money for new money at rates of 10 to 1, 100 to 1, or even higher ratios. Of course, the new currency continues to depreciate at rates similar to that of the old.

Student: You asserted that soaring Federal deficits incite social and political strife. I don 't understand.

Professor: All Federal expenditures other than those for the protection of human life and private property are transfer expenses; they forcibly take income and wealth from one person and give them to another. After all, the federal government has no means of its own; every penny of benefit it bestows is a forced extraction from a taxpayer. And every such transfer is a source of political and social conflict. The beneficiaries argue and fight to defend their rights to the take; the victims feel wronged and hurt. Some may emigrate, but most get embroiled in an endless brawl about social benefits and their ways of payment. When an economic depression finally descends and impoverishes all, the conflict may turn into an armed struggle and civil war. In the end, it may bring forth a "strong man" who, invested with the necessary emergency powers, restores social peace; that is, complete calm under dictatorial rule. All social conflict societies are moving in this direction.

Student: You explained our international indebtedness and the ever rising debt of the federal government, but did not mention the debts incurred by American business and the people themselves, the consumers. Are they economy-minded and prudent with money or are they following in federal footsteps?

Professor: They are following the pattern of the federal government. The very policy that led to the precarious international debt situation also has infected American businesses and consumers. Federal government debt presently is rising at an annual rate of ten percent, household debt at eleven percent, and business debt at 4.1 percent. Any financial institution with direct access to the Fed until recently could borrow funds at one percent and then happily re-lend them at much higher rates. At this time, they may borrow at 1.5 percent and extend credit to house buyers charging six or seven percent and to consumers even higher rates. On both levels, the artificially low rates cause the volume of loans to grow far beyond the level of actual savings. The difference is covered by fiat inflation and credit expansion.

Student: Can you visualize the coming readjustment? How and when should I brace for it?

Professor: I doubt that we'll ever see a run-away inflation similar to those we can observe all over the world. In the United States, I expect the elaborate house of debt to deteriorate long before the dollar crumbles completely. I fear for the financial institutions that are enjoying the boom, extending their credits and maximizing their profits. As soon as interest rates return to market levels, the boom will give way to readjustment, that is, stagflation or recession. Housing prices will decline, which will exert great pressure on the very collateral foundation of the housing boom. Having granted a mortgage loan of 80 to 90 percent of the value of a house, the lender faces substantial losses when its market price falls by 30 or 40 percent. Similarly, as soon as a recession descends on the country and unemployment rises to painful levels, many consumer loans are likely to default, inflicting serious losses on lenders. In short, I expect the house which debt built to crumble long before the U.S. dollar goes to its glory. A wise man guards against this scenario by following Thomas Jefferson's advice: "Never spend your money before you have it."

Total U.S. debt (government, corporate, and individual) is estimated at some $37 trillion, which is more than three times the gross national product. It doubled over the past five years and continues to grow every day. In addition, the U.S. Treasury reminds us of entitlement programs with unfunded liabilities of some $44 trillion. You may say, our children will be able to handle our debt. You may be right! They may follow in our footsteps and load our debt together with their own on their children, in a long sequence of generational debt passage. At the same time, they will depreciate the currency, and thus reduce the value of the debt. The value may fall at various rates, depending on the choices of the politicians in power. Whatever they may be, they will surely do their best to postpone the inevitable.

Bubbles in Real Estate

With stock prices now moving waywardly and unpredictably, many Americans have taken a liking to real estate. They have bought homes in record numbers, as easy credit and low interest rates have enabled many to buy rather than rent a home. And just like stock prices during the 1990s, the value of homes keeps rising as does the debt incurred to buy them. According to Federal Reserve data, American homes now are worth some $13.6 trillion, which is 92% more than a decade ago, while mortgage debt more than doubled to $6 trillion. With all that money rushing into real estate, does it cause prices to surge, as it did in the stock market, or does it manifest rising incomes and growing ownership aspirations?

Searching for an answer to these questions, we must raise and answer yet another question that enfolds the former: is the capital market that guides and drives economic activity allowed to function freely, or is it controlled and manipulated by government regulators? In other words, is an unhampered market rate of interest allowed to direct the employment of capital and labor, and thereby shape present conditions, or is the rate commanded and manipulated by mighty controllers? The answer is obvious: it is set by the governors of the Federal Reserve System, who thereby modify all interest rates and manipulate the capital markets. In recent years, they chose to keep interest rates far below market rates, and thus guide economic activity along lines that differed greatly from those an unhampered market would have directed. They caused massive increases in money and credit, and brought about what economists call "maladjustments," which are the very mainspring of economic recessions and depressions.

Maladjustments in real estate differ visibly from the afflictions of stock and bond markets, which are national or even international in range and scope. Landed property is an inherently local asset that is affected by a great number of local demand and supply factors. The housing market in San Jose, California, has little resemblance to that in Grove City, Pennsylvania, although both are affected by the same Federal Reserve monetary policy. Some places may suffer stagnation or price declines, while others experience feverish booms. There may be bubbles in some parts of the country, while stagnation and recession hold others in their grip. Yet all prices undoubtedly are much higher than they would be in the absence of chronic inflation and dollar depreciation.

The Office of Federal Housing Enterprise Oversight informs us that average housing prices rose 38.3 percent from 1997 to 2002. This knowledge may be of interest to economic historians, but of little use to real estate investors. They are intrigued and lured by local conditions, and the possibility of earning high returns through debt financing when prices soar. A home buyer may put down ten percent of the purchase price and borrow the rest; a price rise of ten percent would double his investment. An annual price increase of just five percent would yield a return of 50 percent on his investment, year after year. While the mortgage loan continually depreciates in purchasing power, the owner's equity rises in step with the rising price of his house. In fact, in less than ten years a ten percent annual depreciation rate will shift one-half of the value of his house to him, without his having made a single loan payment. Surely, he will have to maintain the property and pay interest on the mortgage loan, which may be less than the rent he would have to pay if he were to rent the house.

This leverage of debt financing also works in reverse. When the bubble bursts and housing prices readjust, many new owners lose their entire investment. A ten percent decline in prices wipes out a ten percent owner equity; a thirty or forty percent decline, which is rather common in a bubble crash, not only stamps out his investment, but also may inflict additional losses—unless he walks away from his house and thereby shifts the losses to the financial institution that granted the loan. When the decline is severe and many owners choose to unload their losses on creditors, the crash may jeopardize the solvency of financial institutions that financed the bubble.

Despite such occasional reversals, our age of inflation has made ownership of a home the most effective way to increase personal wealth. While inflation tends to raise interest rates by adding the anticipated depreciation rate to the basic time-preference rate, it also lowers the debtor's risk premium, which may offset the higher depreciation rate. The owner's equity increases in step with the rising price of the house, which simultaneously reduces the risk to the lender. Before the age of inflation, a home buyer needed a down payment of 30 to 50 percent of the purchase price; the age of inflation gradually reduced this rate to 20 or 10 percent, but sometimes 3 percent or less. The lender's price risk is minimal; the buyer may just sit back and let the bubble increase his equity.

Politicians and government officials look with favor on home ownership, as they themselves benefit from such favors. Home buyers enjoy big tax breaks. They can deduct property taxes and the interest on their mortgages from their taxable income. And when they sell their homes, they may exclude up to $250,000 in capital gains from taxable income; married couples may deduct $500,000. And they can do this again and again as long as they live in the home for two of the five years prior to selling.

The prices of manors and mansions have soared above all other housing prices. When the stock market began to retreat and disappoint in 2001, many underperforming funds sought refuge in real estate, and thus caused housing prices to take off. The nouveaux riches of the stock market sought safe harbors in real estate, and those speculators who could not afford such luxury could at least borrow against the equity in their houses and raise their standards of consumption to manor levels. A "refinancing" mania gripped the real estate market and lifted the level of mortgage debt. To take advantage of the current low rates, many debtors chose "variable-rate" mortgages that are readjusted frequently. If interest rates should ever return to market levels and cause real estate prices to decline, many such refinanced houses would not be worth the debt standing against them. In the meantime, most homeowners rejoice about their rising equity which they calculate in nominal prices. If they would compute prices in inflation-adjusted dollars, their profits would be much lower or even turn to losses. In some parts of the country, nominal prices continue to rise moderately while inflation-adjusted prices actually stagnate or even decline.

National statistics tend to understate the risk of loss for many homeowners. They obscure the extreme price swings in individual towns and cities, and blur the particular forces that may reduce or compound the maladjustment. During the 1980s, for example, several West Coast cities enjoyed feverish high-tech and defense-spending booms. Real estate prices soared. A few years later, when high-tech production spread to China, India, and many other places, stagnation settled over many places and prices fell noticeably. In the Silicon Valley, they slid some twenty percent. In recent years, many communities also have been affected by soaring U.S. trade deficits, driven by Federal Reserve easy-money policies and mounting U.S. Treasury budget deficits. As trade deficits rose to more than $500 billion annually, that is, to more than five percent of GDP, American manufacturers of many consumers goods faced growing pressures of foreign competition and were forced to contract. Many communities soon experienced economic declines and rising unemployment, especially in parts and sections of town occupied by the laboring population. While the construction of mansions continued at full speed, and middle class refinancing generated new life in old neighborhoods, heavily-populated urban areas occupied by welfare recipients and unemployed laborers ceased to grow. Apartment rents may have kept on rising, but the prices of such dwellings rarely did.

Throughout the industrial Northeast, many communities, large and small, even endured real depressions as militant labor unions relentlessly boosted production costs and unemployment soared to deplorable levels. The strongholds of labor unions, such as coal mining, the steel industry, the automobile industry, the aerospace industry, trucking, and shipyards, stagnated throughout most of the 1980s and 1990s. In Grove City, Pennsylvania, ugly labor strikes, too numerous to count, finally drove the largest employer out of town and state. In Youngstown, Ohio, high unemployment and deep depression settled on the community when the last steel mill was forced to close its gates.

The local demand-and-supply factors, that often drive the real estate market, may at times be overshadowed by national forces. They surely were overwhelmed during the Great Depression of the 1930s and the six recessions that descended on the country since then. Another recession could do it again. If foreign central banks should tire of financing U.S. trade deficits, the U.S. dollar would plummet in foreign exchange markets, American goods prices would rise, and interest rates would readjust. An international flight from the dollar undoubtedly would delimit the Fed's power to manage interest rates. Rising rates would impact on the housing market and reveal the maladjustments that resulted from many years of rate manipulation. Rising rates would expose ill-designed housing built in wrong quantities, wrong qualities, and wrong neighborhoods. Of course, the monetary authorities would do everything in their power to flush the troubles away. Unaware of any inexorable principles of economics, and infatuated by the coercive powers of government, they are likely to compound the difficulties and make matters worse.

Even if foreign creditors should never tire of financing American trade deficits and U.S. Treasury debt, the maladjustments are calling for correction. The ocean of debt in which many Americans are swimming cannot brook a major rise in interest rates; it may soon force a readjustment. Similarly, the financial bubble engendered grossly inflated price-earnings ratios which call for early readjustment to unimpeded levels. In short, powerful forces, consisting of the value judgments and choices of the people, are working tirelessly to correct the maladjustments in all parts of the economy, including real estate.

* * * *

It is nearly impossible to estimate the magnitude of income and wealth which false interest rates and misleading credit markets redistribute every day. It is unearned lucre that is taken from millions of savers and creditors and bestowed on all kinds of debtors, including millions of mortgagors. Surely, most Americans are both creditors and debtors, but rarely equal in both accounts. Most may be vaguely aware of the transfer process; some may take advantage of it, but only a few may be knowledgeable of the causes that drive the process. Economists are keeping their eyes on the prime movers, the Federal Reserve System and the U.S. Treasury, which wield vast powers over American money and credit, but their voices are barely audible in the din of official pronouncements.

Most Americans trust their political leaders and their media spokesmen, who wax eloquent about the wisdom of Federal Reserve policies and the benefits of Federal spending. They sense the growing importance of government, and especially its primary role in the allocation of inflation lucre. Discerning the important role of politics in their economic lives, many Americans now participate in party politics and join in bitter feuds about government favors. They all want to redistribute the lucre; few would abolish it. They may even favor and support inflationary policies that blow bubbles in real estate and create incomparable opportunities. Unfortunately, they pay little heed to the great economic and social harm done by such policies.

No Conscience in Politics

Many people know how to earn money, but few are aware of what the Federal Reserve System, acting by authority of the U.S. Government, is doing to their money. It is inflating and depreciating the dollar at various rates—at double-digit rates during the 1970s and early 1980s, and at single-digit rates ever since. No wonder many victims readily conclude that thrift and self-reliance are useless and even injurious, and that spending and debt are preferable by far. They may join the multitudes of spenders who prefer to consume today and pay tomorrow, and they may call on government demanding compensation, aid, and care in many forms. Surely, the hurt and harm inflicted by inflation are a mighty driving force for government programs and benefits.

In their discussions and analyses of various problems, economists usually avoid the use of moral terms dealing with ultimate principles that should govern human conduct. Ever fearful of being embroiled in ethical controversies, they seek to remain neutral and "value-free." They do counsel legislators and regulators on the cost-efficiency of a policy, but not on its moral implications. They may offer professional advice on the efficiency of money management, but not on the morality or immorality of inflationary policies. They dare not state that inflation is a pernicious form of taxation which most people do not recognize as such. Authorities of money and banking, rather than taxing authorities, redistribute income and wealth under cover of ignorance. Placed on every person in the form of higher goods prices, the application does not fall equally and simultaneously on every buyer. The people who receive the newly created money first may actually benefit, as goods prices readjust rather slowly. Others, who receive it later or not at all, will have to tighten their belts. Above all, inflation ravishes the savings of countless Americans and turns many into prodigal spenders and debtors.

The biggest debtor also is the biggest inflation profiteer. With some eight trillion dollars in debt, the U.S. federal government is by far the biggest winner. In fact, it gains not only from debt depreciation, which at just three percent amounts to some $240 billion every year, but also from Federal Reserve money and credit creation that enables the U.S. Treasury to suffer annual budget deficits of some $500 billion a year. Without the power to inflate and depreciate the dollar at will, the U.S. government would be a different institution, more like that which the Founding Fathers had envisioned, but endowed with the power of inflation, it has become an almighty organization that redistributes income and wealth, and refashions the social and economic order.

The primary beneficiaries of the new order are its own managers: legislators, regulators, and a huge army of civil servants. They are first in power, prestige, and benefits. Many U.S. Senators and Congressmen are the admired and esteemed benefactors of countless petitioners for handouts and favors. They are revered for every benefit they bestow. And there are the officials of the Department of Commerce with seven benefit programs, the Department of Education with thirty-four programs, the Department of Energy with six, the Department of Health and Human Services with eight, the Department of Housing and Urban Development with fourteen, the Department of the Interior with three, the Department of Labor with nine, the Department of Transportation with nine, and various government commissions and authorities with another ten programs. Federal politicians and agents are the wise and virtuous judges and juries of benefits amounting to more than one trillion dollars every year. How "honorable" would they be, pray tell, without Federal Reserve assistance in financing the deficits and without its power to print more money?

Evil acts tend to breed more evil acts. Inflationary policies conducted for long periods of time not only foster the growth of government, but also depress economic activity. Standards of living may stagnate or even decline as growing budget deficits thwart capital accumulation and investment that are sustaining the standards. Inflation misleads businessmen in their investment decisions, which causes much waste and many bankruptcies. In fact, it is the root cause of the boom-and-bust cycle, which wreaks havoc on economic activity. Indeed, inflation breeds many evils, of which most Americans are unaware.

Since 1971, when President Nixon abolished the last vestiges of the gold standard and repudiated all obligations to meet international obligations with payments in gold, the U.S. dollar has been the dominant world currency. It enables Americans to buy massive quantities of foreign goods and services, suffering annual trade deficits of more than half a trillion dollars now, and making payment in ever depreciating dollars. Foreign central and commercial banks as well as many foreign individuals are using their dollars with the hope that they will retain their purchasing-power in the long run. Asian creditors are holding more than $2 trillion in claims, Japan and China alone an estimated $1.5 trillion between them. A dollar depreciation rate of just 3 percent strips Japan and China of some $45 billion in purchasing power every year. They undoubtedly are suffering such losses in silence because they are mindful of the many benefits they are receiving from amicable relations with the United States. American capital is rushing into China, building many plants and introducing modern technology while some 20,000 young Chinese are studying at American colleges and universities. At the same time, Japanese and Chinese companies are investing surplus dollars in the United States, assuming control over American corporations. If the United States government should ever disrupt this peaceful relationship with discriminatory trade restrictions and painful barriers, the Asian creditors may dump some dollar holdings. The dollar crash would be heard around the globe.

There is no conscience in politics. Economic policies may be changed, reformed, and readjusted because they are ineffective, unproductive, and unpopular, but rarely ever because they are immoral. Debt may be a grievous bondage to an honorable man, but it may be a "national bond" which, in President Roosevelt's words, "is owed not only by the nation but also to the nation." Surely, politicians have a code of laws to observe and obey, but honesty in matters of debt and money is not one of them.

If it is true that we cannot do wrong without suffering wrong, we must brace for more grief to come.

In Search of a Lesser Evil

Most Americans who are unschooled in political and economic thought should have no trouble in national elections. They may vote for candidates who, in their judgment, not only are likely to be honest and trustworthy, but also promise great economic improvements and personal benefits. But some Americans who make an effort to reflect on the records and promises made by the candidates may face difficult questions of conscience. As voters, they may be forced to choose among several candidates for high political office, all of whom are likely to make matters worse. Does their conscience force them to search for and choose the lesser evil or even abstain from participating in the contest?

Guided by old notions of labor disadvantage and exploitation, the political candidates may favor popular labor legislation and regulation that are designed to benefit some workers, but inflict great harm on others. They may advocate prompt government intervention in matters of lay-offs and health-care benefits, affirmative action and NAFTA, which actually may disrupt and depress economic activity. Guided by some concern for old voters, they may promise more Medicare—drug benefits at reduced prices or even complete coverage of total health expenses—at the expense of the well-to-do, old and young alike. All such promises not only tend to aggravate social conflict, but also threaten to impede economic activity. Does the conscience of knowledgeable voters who pay heed to such political promises force them to choose the lesser evil or even withdraw from the political fray?

Surely, they will not vote for candidates walking in the footsteps of Presidents Hoover and Roosevelt, who severed many trade relations with other countries and doubled and even trebled income and business taxes, but will they consent to cast their votes for candidates who are treading on the heels of Presidents Kennedy, Johnson, Nixon, Ford, and Carter? They conducted popular policies that led to chronic "stagflation," that is, a medley of rampant inflation and painful stagnation. By 1980, double-digit inflation was reducing the economic substance of most Americans and economic stagnation was depressing their levels of living. Surely, knowledgeable voters would not choose such candidates—unless they feel compelled to opt for the lesser evil and thus prevent the greater evil. But is it ethical, in accordance with the principles of right and good conduct, to cast a vote for any evil?

Most moral philosophers would answer this question in the affirmative—as long as the lesser evil serves to prevent the greater evil. To save a life, I may lie and deceive a raving assassin who is searching for his victim. But does this moral principle apply to the world of politics? This writer is inclined to deny its applicability because a vote for one evil does not lead to inactivity, but rather to ever more evil; social and economic policies spring from social and economic thought that may give rise to many consequences.

If I approve of any labor legislation that interferes with actual market conditions, I may invite ever more legislation and regulation. If I favor some health-care benefits for some people at the expense of other people, I may not be able to object to "further improvements." If I approve of any "affirmative action," that is, government programs allocating jobs and resources to members of special groups, such as minorities and women, I may, in the end, clear the way for "universal affirmation," that is, the political command order. If I approve of some government protection of American labor from the competition of foreign labor in NAFTA countries, I may not be able to object to ever "better protection." If I look with favor upon some free medical services to the elderly, I may not be able to deny them ever more benefits. After I say "yes" to benefits and entitlements, how can I later say "no"?

In politics, any vote for lesser evil may pave the way for greater evil. Awareness of this tendency may cause many Americans not to participate in the election process; they do not want to feel responsible for the manifestation of much evil in politics. Other Americans may cast their votes for a minority party that is not expected to participate in any policy-making. Briefly sharing the political platform with the major parties during election time, minority parties may be able to raise objections to the aspirations of the policy-shaping parties, but political objections rarely lead us in new directions. They cannot take the place of thorough information and earnest education of the inexorable principles that affect our lives.

The lesser-evil road leads straight to the command system. It has many stops at which the drivers take a breather and refuel for the next lap. Some may wonder and argue about the costs and affordability of the trip, but as long as there are affluent taxpayers left, they are likely to push ahead. They may press on although the road is hard and difficult and every mile is paid for with social conflict and political strife.

As Far as the Eye Can See

Many officials, politicians, and media commentators are convinced that inflation is obsolete and passe. They are telling us that the rise and decline of inflation during the past forty years has been the most disruptive force, but that the Federal Reserve's staunch anti-inflationary policies have finally removed the danger. They brought us, we are to believe, great improvements in efficiency and productivity, which in turn led to increases in wages, profits, and living standards.

Although this kind of information and literature on inflation is very large, much of it is tainted with political interests which are rather self-serving. Inflation actually is an ideological and political disease, the early symptoms of which appeared during the 19th century; it contaminated the world in the 20th century, and is bound to rage on as far as the eye can see. In fact, inflation is a morbid condition that is gnawing at the very foundation of our civilized order. Its many aftereffects may be too sinister and baleful to contemplate.

Most college textbooks define inflation as "persistent and relatively large increases in the prices of goods and services." Its opposite is "deflation," a process of generally declining prices. Some may even remember the original meaning of the word "inflate": to fill up or blow up the volume of money beyond the needs of business, causing its value to decline. But few writers ever search for the ultimate causes that make goods prices rise. Surely, they may blame wars and preparations for war as the common cause of inflation; in particular, the costs of the Vietnam War during the 1970s, which led to double-digit price inflation. They may point to the quadrupling of oil prices in 1974 by the Organization of Petroleum Exporting Countries (OPEC) and many other contributing factors, but few writers mention the ideological and institutional conditions that spawned our age of inflation.

Few economists ever suggest that "fiat money" and "fiduciary credit" are the pillar and post of our age of inflation. Paper money that is decreed to be legal tender and unbacked deposits resting thereon are now our legal media of exchange. They are dwindling in value, depreciating our savings and enriching some debtors, especially the body politic, causing boom and bust cycles, and politicizing nearly every aspect of our economic and social lives. Sooner or later, they are bound to lead us into another recession or depression, followed by more inflation, price and wage controls, and finally, currency reform, which starts the sequence all over again. Indeed, our monetary order breeds much economic and political conflict and may lead us straight to a political command system, with all its evil ramifications.

Major intellectual and ideological strongholds of the system are the universities, big daily newspapers, the media networks, and Hollywood studios. A few talk-show hosts may criticize their excesses, but rarely do any teaching of their own. A few educators who point to the disease are barely heard in the din of the mainstream chorus. And fewer yet have the courage to dwell on the importance of balanced budgets and monetary freedom. He who would dare to propose a gold-coin standard would be pitied and spurned as a relic from the distant past. Hysterical hostility toward the gold standard unites all welfarists and socialists.

Inflationism is a dreadful cancer that is gnawing at the backbone of the civilized order. This diagnostician readily discerns three stages of ideological progression leading not only to the destruction of the money we know, but also to much economic and political conflict and strife. In the first stage, which became clearly visible during the second half of the 19th century, most countries acquired a central bank designed to regulate and control the supply of money and credit, with the goal of guiding and regulating economic life. After all, doctrines of economic and social conflict began to sway the thinking of many thought leaders. They became social and political reformers laboring diligently to change the economic system. They created a vast mass of social legislation, beginning with the Bismarckian reforms of the 1880s in Germany, followed by Lloyd George's reforms in Britain increasing the death duties, raising taxes on large incomes, taxing undeveloped and non-income producing land, giving government a portion of rising land values, and, in the footsteps of Otto von Bismarck, passing much labor legislation. In the United States, Woodrow Wilson introduced the "New Frontier" and established the Federal Reserve System in 1913. Soon thereafter, all countries enacted major social reforms: a few went all the way to socialism, even communism or some other form of authoritarianism.

In the second stage of inflation progression, the central banks were gradually liberated from the shackles of the gold standard. During World War I and World War II all banks were forced to lend a financial hand to the fighting. Thereafter, the gold-coin standard gave way to the gold-bullion standard, then gold exchange standard, and finally the gold-dollar standard. In 1971, when American gold payment obligations exceeded by far the reserves of gold, President Nixon halted all gold payments. The United States thereby led the world into the third stage of inflation progression: an unrestricted fiat standard.

Fiat money is non-convertible money that is made legal tender by the decree, or fiat, of government and the order of courts. It is paper money, and credit based thereon. As it can be proliferated at will, governments have used and depreciated it throughout history. There cannot be any doubt that our fiat dollars are destined to go the way of all others. The only question open to discussion is the length of time it will take. The future sometimes is likened to an opaque mirror in which we merely see the dim outlines of our own worried faces. But this writer sometimes catches sight not only of his own old face, but also of the evils of inflation for decades to come. He searches in vain for the faces and names of influential authors and educators who would disapprove of deficit spending and Federal Reserve financing, leaders who would call for balanced federal budgets and honest payments in gold. And even if there were a few such dreamers, old policies are not easily changed and old customs not easily broken; inflation is likely to drag on for decades to come.

Looking in the opaque mirror we can see a host of mentors, educators, public servants, and politicos who not only would stand bravely by every inch of "social progress" but also would want to advance another yard. They would labor diligently to repair and expand the public education system, the Medicare and Medicaid healthcare system, and the Social Security and federal pension system. They would reorganize the labor market, the agricultural market, the federal and state bureaucracies, and, above all, the federal money and banking system. In short, they are marching in the old direction of social reform, just like their predecessors. Several generations of social reformers built the system; even if some friends of freedom would come in sight, it would take several generations to reverse the trend.

A political colossus does not readily turn around. In fiscal year 2006, the federal government plans to spend some $1.1 trillion, or 43 percent of all its outlays, on Social Security, Medicare, and Medicaid. Two years from now, in 2008, the outlays are bound to accelerate as "baby boomers" will be eligible for the trough. They may claim one-half or more of all federal spending. Moreover, the U.S. military presently is spending more than half a trillion dollars a year. If, in coming months, Muslim terrorists should strike

Americans anywhere in the world, the American military undoubtedly would strike back, which again would boost federal outlays. But no matter how high such expenditures may be, they would not be allowed to infringe on social welfare benefits. Surely, the budget deficits are bound to continue and the Federal Reserve is expected to cover them.

Federal Reserve deficit financing has many hurtful consequences which are felt throughout the world. It creates balance-of-payment deficits, which by now amount to some $650 billion a year, or some $2,000 for every man, woman, and child. The United States must borrow foreign capital in this amount to prevent the dollar from falling. Fortunately, Asian central banks have come to the rescue and acquired large quantities of dollars in order to keep their own currencies low, and their export industries growing and prospering. But if the foreign appetite for dollars should ever diminish as a result of growing doubt about the credit worthiness of the world's largest debtor, the dollar surely would fall and jar the financial order of the world.

There is no escape from the vast imbalances in international trade and finance. They will be corrected, sooner or later, by the inexorable principles that govern human action. We may be in the dark only about the time of readjustment and the response by political authorities. But we are ever aware that politics is an ugly struggle that determines "who gets what, when, and how." It is the favorite occupation of people who serve special interests, who have axes to grind, and public careers to advance. It is a game in which benefits are bestowed according to political skill and connection, rather than merit. It is an arena of pressures and counter-pressures in which emotion often prevails over reason, and power over justice. Conflict politics has nothing to do with morals and ethics; it is a bitter battle about position, benefits, privileges, taxes, and obligations. Some 500 years ago, Niccolo Machiavelli described it rather well: "The state is no organism capable of bringing either moral or material improvements to the populace, but merely a vehicle of power for the men and party in power."

Most critics of the economic order usually point to the men in power who held forth and led the way. They may indict Presidents Herbert Hoover, Franklin D. Roosevelt, Harry S. Truman, Dwight D. Eisenhower, John F. Kennedy, or any Democratic or Republican successor for having led them astray and mismanaged the economic structure. Surely, these men led the way to economic and social reform, but they merely sailed with the ideological wind and aimed at popular targets. They all steered toward goals which the scholars and academics had espoused and promoted long before them. There cannot be any doubt that "inflation economics," as it is practiced today, primarily is the intellectual creation of John Maynard Keynes and his many American disciples such as A. P. Lerner, O. Lange, A. Bergson, P. M. Sweezy, W. Fellner, and P. Samuelson. They viewed social welfare in terms of full employment and easy-money policies, which is the most influential economic formulation of our time. It appeals to both practical politicians and theoretical economists. Moreover, many never tired of discovering and deploring labor exploitation and exorbitant capitalist profits. Conflict doctrines are proclaimed all over the world not only in the teaching of economics, economic history, and sociology, but also in the halls of politics. They are promulgated on the floor of the U.S. Congress by members of both parties, as well as by most masters and gurus of the media. They make sure that inflation presses on without end.

Also by Hans F. Sennholz

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Money and Freedom, 1985
Spanish: Moneda y Libertad, 1987
Polish: Pieniadze I Wolnosc, 1991

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