TESTIMONY BEFORE

THE U.S. HOUSE COMMITTEE ON FINANCIAL SERVICES

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Dr. Joseph T. Salerno
Professor of Economics
Lubin School of Business
Pace University
One Pace Plaza
New York, NY 10038
jsalerno@pace.edu

Joseph T. Salerno received his Ph.D. in economics from Rutgers University. He is currently a professor of economics in the Finance and Economics Department in the Lubin School of Business of Pace University in New York. He is Academic Vice President of the Ludwig von Mises Institute and the editor of the *Quarterly Journal of Austrian Economics*. He is a research associate of the Foundations of the Market Economy in the economics department at New York University and a policy expert for the Heritage Foundation in Washington, D.C. Dr. Salerno has published numerous essays and articles in scholarly books and popular and academic journals. He has authored or co-authored three books and edited several others. His most recent book, *Money: Sound and Unsound*, was published in 2010. He lectures frequently in both the U.S. and internationally and more than fifty of his lectures are available online. He is also frequently interviewed on broadcast and online radio shows and has appeared on CSPAN and Fox News television programs.

Since it began operations in 1914 the Federal Reserve System ("the Fed") has presided over a relentless decline in the value of the U.S. dollar. Prices increased in 83 of the 97 years of the Fed's existence. Over the last 60 years, beginning in 1950, prices rose in 58 of them. As a result the cumulative loss of the dollar's buying power during the Fed's existence has been staggering. For example, today a consumer pays $22.13 to purchase a basket of goods comparable to a basket that a consumer in 1913 would have paid $1.00 for. This means that since 1913 the dollar has lost 95 percent of its purchasing power and that today's dollar is worth roughly a nickel in terms of the pre-Fed dollar of 1913. The Fed's performance in safeguarding the value of the dollar has been particularly abysmal since 1971, when President Nixon closed the "gold window" and completely unshackled the Fed from the remaining restraints of the gold standard. Since then the price level has more than quintupled, so that today's dollar retains only 19 cents of the purchasing power of the 1971 dollar.

Now the view held by Chairman Bernanke and other mainstream macroeconomists is that the Fed was chastened and enlightened by the disastrous consequences of the inflationary monetary policy that it pursued in the 1970s. According to this view the enlightened monetary policy that the Fed began to follow in the 1980s was responsible for the so-called "Great Moderation" from

1984 to 2004. During this period, price inflation was stabilized at moderate levels and the economy grew more steadily while unemployment remained low. But this story conveniently ignores the October stock market crash of 1987, the sudden collapse of the S&L industry in 1989-1990, and the high-tech bubble of the late 1990s that culminated in the stock market collapse and the recession of 2001. But even the claim that inflation remained moderate during this period is dubious when viewed from a longer run perspective. For if we take 1984 as the beginning of the "The Great Moderation," average consumer prices have more than doubled and the dollar has lost 52 percent of its purchasing power since then. And this is accepting at face value the dubious method of calculating official CPI indexes.

Now, some economists have responded to this criticism of the Fed's performance by arguing that "money is neutral in the long run." Their point is that average wages and salaries, which are the prices of labor services, rise roughly in proportion to inflation *in the long run*. So, if prices are 20 times higher now than they were in 1913, well then so are incomes twenty times higher, and therefore, no one is really worse off in terms of their real standard of living. There are serious problems with this argument but I will mention only one here.

The key point is that prices and wages do not all increase at the same time during inflation. When the Fed initially expands the money supply, not everyone receives a share of the new money immediately. There is no Friedman-Bernanke helicopter that spreads the money evenly throughout the country. New money and credit is always injected into the economy at specific points through bank loans and government purchases and subsidies. Some firms, financial institutions, and households necessarily receive the new money before others in the economy. The money incomes of these groups rise before prices go up, enhancing their ability to purchase real goods and services and increasing their standard of living. As these first recipients of the new money increase spending on investment and consumption, prices begin to rise and inflation sets in. The rest of the entrepreneurs and laborers, who did not initially receive the newly created money, suffer a decline in their living standards because they must pay rising prices for the goods they purchase while their selling prices and wages remain unchanged. Eventually, as the new money works its way through the economy—and this may take months or even years—their product prices and wages finally adjust to the depreciation of the dollar. In the meantime, they suffer an arbitrary and unseen inflation tax that redistributes part of their real income and wealth to those who have privileged access to the new money created by the Fed—for example, subsidized agribusiness, defense contractors, the creditors of financial institutions bailed out by the Fed and so on.

Furthermore, if inflation is a continuous process as it has been in the U.S. since World War Two, then many wage-earners and entrepreneurs find their living standards permanently depressed as their wages and sale prices persistently lag behind the rising prices they must pay. And of course, those living on fixed incomes such as pensions and life insurance annuities suffer a cruel and relentless decline of their living standards that is never reversed.

So, it is indeed true that in the long run inflation results in average wages and other productive incomes rising in rough proportion to average prices. But this statistical correlation conceals the true devastation wreaked by inflation. The rapid decline of the purchasing power of the dollar, especially since 1971, has involved a massive and surreptitious transfer of real income and wealth from productive laborers, entrepreneurs and investors to those privileged corporations and financial institutions that are the recipients of government largesse and bailouts. Additionally, in orchestrating this inflationary process, the Fed has repeatedly driven the interest rate below its natural market level, misleading investors and entrepreneurs and causing disastrous asset market bubbles, unsustainable business investments and the creation of jobs that are not consistent with consumer preferences. It is the arbitrary manipulation of the interest rate by the Fed that has caused the financial meltdowns and recessions that the U.S. economy has suffered over the last four decades.

One of the arguments in favor of inflation that has recently come into vogue again is that moderate inflation is desirable to prevent the far greater evil of deflation. In the past decade, this view has been promoted by many mainstream economists, most notably former Fed Chairman Greesnpan and current Fed chairman Bernanke. But this view is based on a fundamental confusion. It confuses deflation with depression, which are two very different phenomena. Falling prices or deflation is, under most circumstances, absolutely benign and the natural outcome of a prosperous and growing economic. The fear of falling prices is thus a phobia, a "deflation-phobia," which has no rational basis in economic theory or history.

Let me explain. As technology advances and saving increases in a progressing economy, entrepreneurs and business firms are given the means and the incentive to invest in new methods of production, which in turn enables them to lower their costs and expand their profit margins. In a given market, the natural result is an increase in the supply of the good and more intense competition among its suppliers. Assuming no change in the money supply and continuing technological innovation, this competitive process will drive the production costs and price of the good ever downward. Consumers will benefit from the falling price because their real wages will continually increase as each dollar of income commands an increasing quantity of the good in exchange.

This is not merely abstract theoretical speculation but is precisely the process that occurred in the past four decades with respect to the products of the consumer electronics and high-tech industries, such as hand calculators, video game systems, personal computers, HDTVs, and medical lasers. Thus, for example, a mainframe computer sold for $4.7 million in 1970, while today one can purchase a PC that is 20 times faster for less than $1,000. The first hand calculator was introduced in 1971 and was priced at $240, which is $1,400 in terms of today's inflated dollar. By 1980, similar hand calculators were selling for $10 despite the fact that the 1970s was the most inflationary decade in U.S. history. The first HDTV was introduced in 1990 and sold for $36,000. When HDTVs began to be sold widely in the United States in 2003 their prices ranged between $3,000 and $5000. Today you can purchase one of much higher quality for as little as $500. In the medical field, the price of Lasik eye surgery dropped from $4000 per eye in 1998, when it was first approved by the FDA, to as little as $300 per eye today.

Now no one, not even a Keynesian economist, would claim that the spectacular price deflation in these industries has been a bad thing for the U.S. economy. Indeed the falling prices reflect a greater abundance of goods which enhances the welfare of American consumers. Nor has price deflation in these or other industries diminished profits, production and employment. In fact, their growth has been just as spectacular as decline in the prices of their products and has been caused by it. But if deflation is a benign development for both consumers and businesses in individual markets and industries than why should we fear a fall in the general price level, which of course is nothing but an average of the prices of individual goods? The answer given by theory and history is that a falling price level is the natural outcome of a dynamic market economy operating with a sound money like gold.

Under a gold standard, prices naturally tend to decline as ongoing technological advances and investment in additional capital rapidly improve labor productivity and increase the supplies of consumer goods while the money supply grows very gradually. For instance, throughout the nineteenth century and up until World War I, the heyday of the classical gold standard, a mild deflationary trend prevailed in the U.S. As a result, an American consumer in the year **1913** needed only $**0.79** to purchase the same basket of goods that required **$1.00** to purchase in **1800.** In other words, due to the gentle fall in prices during the nineteenth century, a dollar could purchase 27 percent more in terms of goods in 1913 than it could in 1800.

Contrary to our contemporary deflation-phobes, the secular fall in prices under the classical gold standard did not inhibit economic growth in the U.S. In fact deflation coincided with spectacular transformation of the United States from an agrarian economy in 1800 to the greatest industrial power on earth by the eve of World War One. If we examine the data more closely, we find that the years from

1880 to 1896 included the decade of the most rapid growth in U.S. history. Yet, during this period, prices fell by almost 30 percent, or by 1.75 percent per year, while real income rose by about 85 percent, or roughly 5 percent per year. More generally, a 2004 study of 73 episodes of deflation from sixteen different countries dating back to 1820 indicates that only 8 of the 73 episodes of deflation involved recession or depression. It also indicates that 21 of the 29 depression episodes involved no deflation. The authors of this study, Andrew Atkeson and Patrick J. Kehoe conclude, "In a broader historical context, beyond the Great Depression, the notion that deflation and depression are linked virtually disappears." Even when the Great Depression is included in the data, they find that link between falling prices and negative economic growth is economically insignificant.[1]

Ironically, while Chairman Bernanke just affirmed again a few days ago that the Fed will persist in its inflationary policy of quantitative easing to ward off the imaginary threat of falling prices, signs of inflation abound. The prices of consumer food staples have risen by 6 percent over the past year, with the prices of beef, bacon, butter and lamb rising by 10 percent or more. The U.N. index of grain export prices has risen by 70 percent in the past year and stands at its highest level in 21 years. Gasoline prices have surged 49 percent in the last six months. According to IMF statistics, commodity prices are up by 33 percent in the past

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[1] Andrew Atkeson and Patrick J. Kehoe, ""Deflation and Depression: Is There an Empirical Link," *American Economic Review* Papers and Proceedings 94 (May 2004): 99–103.

year; metals prices by 40 percent; energy prices by 30 percent; crude oil prices by 31 percent; and commodity industrial inputs by 40 percent.[2] As a result of skyrocketing prices of agricultural products such as corn, wheat, soybeans and other crops, the price of farmland in the U.S. has been soaring, particularly in the Midwest where land prices increased at double-digit rates last year and regulators fear that a bubble is forming.

Not only does Chairman Bernanke seem unfazed by these inflationary developments, but, what is more astounding, he appears to welcome the rapid increase in stock prices as evidence that QE2 is working to right the economy. When it became apparent that the Fed's $600 billion buying program for treasury bonds had failed to reduce long-term interest rates as intended but caused them to rise instead, Mr. Bernanke desperately sought another sign that QE2 was working. While he denied that the Fed was responsible for rapidly rising commodity prices, he credited Fed with re-igniting the stock market boom. Oddly, he seized on the Russell 2000 index of small cap stocks, which has increased 25 percent in the last six months, stating "A stronger economy helps smaller businesses." In other words, despite the stagnant job creation and sluggish growth of real output, Mr. Bernanke has declared Fed policy a success on the basis of yet another financial asset bubble that threatens again to devastate the global economy. This would be

[2] Commodity data is from Index Mundi available at http://www.indexmundi.com/commodities/

farcical were it not so tragic. But what else can be expected from the leader of an institution whose very rationale is to manipulate interest rates and print money.

United States House of Representatives
Committee on Financial Services

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3. Business Address and telephone number: [redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
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