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SUBCOMMITTEE ON DOMESTIC MONETARY POLICY AND TECHNOLOGY
COMMITTEE ON FINANCIAL SERVICES
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Dr. Paul and committee members, thank you. The first decade of this century had the lowest rate of economic growth of any decade since the Great Depression. Employment growth was the lowest in six decades. Inflation-adjusted equity prices fell sharply. In large part, this reflects faulty government policies. On the fiscal side, federal spending soared, increasingly financed by borrowing. The ratio of national debt to output is at a historic high for a relatively peaceful period. On the monetary side, we had the worst financial crisis since the Depression, with many iconic financial institutions closing their doors or surviving only because of federal bailouts. And, despite huge federal exertions on both the fiscal and monetary side, we have the weakest recovery going on now in the lifetimes of most persons in this room. Moreover, the huge run-up in the ratio of federal debt to output will be a significant drag on the economy for many years, and may well lead the Fed to monetize debt, unleashing a wave of inflation that can only undermine our economy.

Let me add some more factual detail. Between December 2007 and December 2010 –three full years-- employment fell by over seven million in the United States, despite a first $160-180 billion stimulus package in early 2008, a supersized second one of nearly $800 billion in early 2009 and the subsequent addition of four trillion dollars in debt through massive deficit spending. On the monetary side, the monetary base more than doubled as the Federal Reserve gave banks literally a trillion dollars in excess reserves. The Fed pushed real interest rates into the negative territory in an attempt to provide monetary stimulus. Yet job formation was persistently negative, and we had the worst downturn in post-war history. Far from providing stimulus, the combined easy money monetary policy and wildly expansionist fiscal policy scared the heck out of business persons and investors who were further scared by all the President's bashing of capitalists, the government takeover of iconic private corporations like General Motors, the passage of an unpopular, costly, and exceedingly inefficient health care bill, the restrictions imposed by Dodd-Frank, and so on. Businesses literally accumulated two trillion dollars in cash, and the price of gold rose by about 80 percent from Election Day 2008 as investors increasingly worried about inflation.

Turning to the 2008 financial crisis, while private irrational exuberance no doubt occurred, the crisis largely resulted from three types of government failure. First, the Federal Reserve for years prior to the crisis pursued an easy-money policy that reduced interest rates below levels justified by human behavior and market conditions. This led to an unsustainable and artificial inflation in housing prices. Second, the Feds encouraged imprudent lending practices through such things as the Community Reinvestment Act and HUD policies going back to the 1990s designed to promote home ownership. Third, Fannie Mae and Freddie Mac, government sponsored corporations, promoted totally inappropriate lending practices that contributed to the housing bubble and foreclosure mess. Congress blocked attempts to rein in these companies, no doubt because of the campaign contributions they generated.

You might say that the wildly expansionary policies of the Federal Reserve have not harmed the economy; we averted a meltdown of the financial system, the economy is beginning to recover, and the much talked about inflation threat has not occurred. But I think that is too optimistic. The recovery is by many measures the weakest since the Depression amidst the most aggressive fiscal and monetary policy stimulus of any in American economic history save that surrounding World War II. Inflation has been averted in large part because a frightened consuming and investing public has been hoarding cash rather than spending. The election results of 2010 have forced some moderation or led to anticipated moderation in the policies frightening consumers and investors, so economic activity is increasing a bit. At some point, banks will start to lend some of their huge excess reserves, increasing the money stock and unleashing inflationary forces. Fed Chairman Bernanke says “don't worry; I will not let that happen,” but the markets are not overwhelmingly trusting of this former academic, with good reason. The king size federal deficit is increasingly raising interest costs on the debt, and the Fed will feel pressures to monetize that debt and try to keep interest rates low to minimize debt service costs. All of this will increase inflationary fears that can only be restrained by the Fed selling bonds and doing other things to reduce excess reserves and the monetary base, something that seems exceedingly unlikely as we approach a presidential election year. It is revealing that the dollar has generally fallen against an equally challenged currency, the Euro, itself under attack because of the fiscal and monetary excesses of European governments. The price of gold was $740 an ounce on Election Day in 2008 and is now over 80 percent higher. Scared people run to gold. How long will it be that before ratings on U.S. government bonds will be reduced?

I am an economic historian, and both economics and historical experience demonstrate that federal incursions into economic activity are counterproductive; some textbooks talk about the Policy Ineffectiveness Theorem. Aggressive deficit spending and Federal Reserve monetary expansion led to stagflation in the 1970s. Japan went on a huge binge of stimulus spending in the 1990s and economic growth virtually ground to a halt. The excesses of the European welfare state and its funding are causing crises all over the European Union, from Ireland to Greece. The Obama Administration engaged in stimulus plans accompanied by rising, not falling unemployment. Bail outs and “too big to fail” policies have created a huge moral hazard problem. The Federal Reserve has engaged in huge purchases of government long term bonds and mortgages to keep long term interest rates low, but long term interest rates are *not* falling as concerns about potential inflation justifiably have risen. By many indicators, this is the weakest postwar recovery. The Fed and the government have monetary and fiscal time bombs threatening both short term recovery and long term financial and economic vitality.

Lowell Gallaway and I have reviewed the 20th century from the standpoint of explaining variations in unemployment in our book *Out of Work: Unemployment and Government in Twentieth-Century America*. Variations in unemployment rates can be explained by changes in the productivity-adjusted real wages received by labor. Other things equal, rises in productivity or prices tend to have the impact of lowering unemployment, as does falling money wages. This implies inflationary monetary policies will increase employment and lower unemployment –the Phillips Curve phenomenon. But consistent inflation changes expectations, and reduces the willingness of workers to supply their services at any given price, typically leading to increases in unemployment. Unemployment during the highly inflationary 1970s, for example, was higher on average than in the less inflationary 1950 and 1960s. Government attempts to manipulate wages and prices have employment effects. Wage enhancing policies like minimum wage laws or pro-union legislation typically raise unemployment rates, for example. Monetary policy that increases an expectation of price stability is usually associated with relatively robust employment conditions, as we observed in the 1920s, 1950s, most of the 1960s, and, to a somewhat lesser extent, in the period from about 1985 to 2000. Monetary and fiscal activities that promote productivity advances likewise increase employment opportunities and tend to reduce unemployment. Nearly every major spike in unemployment in the 20th century is associated with some government actions that led to temporary wage-price-productivity dis-coordination: the depression of 1920-22 was an outgrowth of explosive monetary expansion followed by deceleration and reversal of that growth in the World War I era. The 1929-41 Great Depression reflected a downturn prompted by a consumption bubble arising in large part from excessive monetary growth, and then various strategies designed to raise wages, ranging from moral suasion under President Hoover to laws such as the National Industrial Recovery Act and the Wagner Act under President Roosevelt. The downturns of the mid-1970s and 1981-82 are related first to the ineffectiveness of monetary and fiscal expansion in the midst of rising inflationary explanations, and then to the effects that the reversal of monetary expansion had temporarily on real wages and thus labor markets.

As an economic historian, I am alternatively amused and saddened by a richly ironic fact. The Federal Reserve Act was in large part a consequence of concerns growing out of the 1907 banking crisis. In that crisis, bank runs in New York City imperiled major institutions at a time when many country banks kept enormous reserves in New York. An ad hoc group of private bank officials, dominated by J.P. Morgan, put together a fund that was used to head off runs on some key institutions, moderating the banking crisis. The feeling grew that it is not appropriate to have a single man, even one like J.P. Morgan, have so much discretionary power over the banking system and the economy. Yet today, a single man, Ben Bernanke, backed by a small number of others, makes huge decisions about responding to the current crisis. Ben Bernanke is the new J.P. Morgan, but at least Morgan's behavior was constrained by the fact that he, personally, had a good deal of wealth at stake as a consequence of his actions, whereas Bernanke gets paid the same whether he succeeds or fails.

What to do? Our nation achieved economic supremacy from 1871 to 1914, a period of a gold standard, near price stability and no central bank. Consumer prices in 1914 were within 10 percent of what they were in 1871. We can learn from that experience. To restore monetary stability, ideally we would ultimately consider retreating from fractional reserve banking where even moderate declines in confidence potentially lead to devastating consequences. But more immediately, we need to limit monetary growth, and given human weaknesses, probably the best way to do that ultimately is by having a gold standard or some variant that removes or dramatically reduces the discretion of central bankers. On the fiscal side, politicians unfettered by rules behave like unsupervised alcoholics in liquor stores. Thus we need some sort of constitutional constraints on governmental fiscal actions. Practically, changes of this magnitude take time. In the short run, however, you can start holding the Fed's feet to the fire; perhaps, for starters, you should establish price stability as the single monetary mandate for the Fed, repeal the Humphrey-Hawkins Act, and privatize or abolish Fannie Mae and Freddie Mac. Private markets handled mortgages and other lending for generations successfully without federal intervention, and they can do it again. Thank you.

United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
Richard Vedder	Myself
3. Business Address and telephone number: [redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2006, related to the subject on which you have been invited to testify? ☐ Yes ☒ No	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2006, related to the subject on which you have been invited to testify? ☐ Yes ☒ No

6. If you answered "yes" to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

Richard K. Vedder

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