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Committee on Financial Services, Subcommittee on Domestic Monetary Policy and Technology

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Mr. Chairman and members of the committee, I thank you for the opportunity to address the issue of today's hearing: "Can Monetary Policy Really Create Jobs?" Since I am an academic economist, you will not be surprised to learn that I believe that the correct answer to this question is: "yes and no." Monetary policy under the direction of the Federal Reserve has a history of creating *and destroying* jobs. The reason for this is that the Fed, like all other central banks, has always been a generator of boom-and-bust cycles in the economy. Why this is so is explained in three classic treatises in economics: *Theory of Money and Credit* by Ludwig von Mises, and two treatises by Nobel laureate economist F.A. Hayek: *Monetary Theory and the Trade Cycle* and *Prices and Production.* Hayek was awarded the Nobel Prize in Economic Science in 1974 for this work. I will summarize the essence of this theory of the business cycle as plainly as I can.

When the Fed expands the money supply excessively it not only is prone to creating price inflation, but it also sows the seeds of recession or depression by artificially lowering interest rates, which can ignite a false or unsustainable "boom" period. Lower interest rates induce people to consume more and *save less*. But *increased* savings and the subsequent business investment that it finances is what fuels economic growth and job creation.

Lowered interest rates and wider availability of credit caused by the Fed's expansionary monetary policy causes businesses to invest more in (mostly long-term) capital projects (primarily real estate in the latest boom-and-bust cycle), and there *is* an accompanying expansion of employment in those industries. But since the lower interest rates are caused by the Fed's expansion of the money supply and not an increase in savings by the public (i.e., by the free market), businesses that have invested in long-term capital projects eventually discover that there is not enough consumer demand to justify their investments. (The reduced savings in the past means consumer demand is weaker in the future). This is when the "bust" occurs.

The economic damage done by the boom-and-bust policies of the Fed occur in the boom period when resources are misallocated in the ways described here. The “bust” period is actually a necessary cure for the economic miscalculations that have occurred, as businesses liquidate their unsound investments and begin to make decisions on realistic, market-based interest rates. Prices and wages must return to reality as well.

Government policies that bail out businesses that have made these bad investment decisions will only delay or prohibit economic recovery while encouraging more of such behavior in the future (the “moral hazard problem”). This is how short recessions can be turned into seemingly endless ones. Worse yet is for the Fed to create even more monetary inflation, rather than allowing the necessary economic adjustments to take place, which will eventually set off another boom-and bust cycle.

As applied to today’s economic situation, it is obvious that the artificially low interest rates caused by the policies of the Greenspan Fed created an unsustainable boom in the housing market. Thousands of new jobs were in fact created – and then destroyed –giving an updated meaning to Joseph Schumpeter’s phrase “creative destruction.” Many Americans who obtained jobs and pursued careers in housing construction and related industries realized that those jobs and careers were not sustainable after all; they were fooled by the Fed's low interest rate policies. Thus, the Fed was not only responsible for causing the massive unemployment that we endure today, but also a great amount of what economists call "mismatch" unemployment. The skills that people in these industries developed were no longer in demand; they lost their jobs; and now they must retool and re-educate themselves.

The Fed has been generating boom-and-bust cycles from its inception in January of 1914. Total bank deposits more than doubled from 1914 to 1920 (partly because the Fed financed part of the American involvement in World War I) and created a false boom that turned to a bust with the Depression of 1920. GDP fell by 24% from 1920-1921, and the number of unemployed more than doubled, from 2.1 million to 4.9 million (See Richard Vedder and Lowell Galloway, *Out of Work: Unemployment and Government in Twentieth-Century America*). This was a more severe economic decline than was the first year of the Great Depression.

In *America's Great Depression* economist Murray N. Rothbard demonstrated that, once again, it was the excessively expansionary monetary policy of the Fed – and of other central banks – that caused yet another boom-and-bust cycle that spawned the Great Depression. It was not the Fed's subsequent restrictive monetary policy of 1929-1932 that was the problem, as Milton Friedman and others have argued, but its previous *expansion*. The Fed was therefore guilty of contributing greatly to the massive unemployment of the Great Depression.

In summary, the Fed's monetary policies tend to create temporary and unsustainable increases in employment while being the very engine of recession and depression that creates a much greater degree of job destruction and unemployment.

United States House of Representatives
Committee on Financial Services

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Thomas J. DiLorenzo	I represent myself.
3. Business Address and telephone number:	
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