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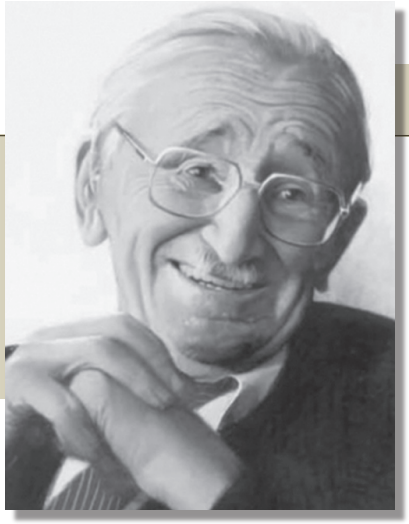

THE HAYEK LECTURE

The Sixth Annual Lecture
November 30, 2010

Money, Markets and Sovereignty

by

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&

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The Hayek Lecture

Political philosopher and Nobel laureate F. A. Hayek, author of groundbreaking works such as *The Road to Serfdom* and *The Constitution of Liberty*, was the key figure in the twentieth century revival of classical liberalism. He was also a formative influence on the Manhattan Institute. When our founder, Sir Antony Fisher, asked how best to reverse the erosion of freedom, Hayek advised him not to begin with politics *per se* but to fight first on the battlefield of ideas. Our Hayek Lecture affirms and celebrates this mission. The Lecture is delivered by the recipient of the Hayek Prize—a new Manhattan Institute prize that honors the book published within the past two years that best reflects Friedrich von Hayek's vision of economic and individual liberty. The purpose of the award is to recognize the long-running influence of the *Road to Serfdom* and to encourage other scholars to follow Hayek's example. The winner of the Hayek Prize is chosen by a selection committee of distinguished economists and journalists and asked to deliver our annual Hayek Lecture. The winning author receives a $50,000 financial prize.

The Manhattan Institute gratefully acknowledges the support of Thomas and Diane Smith, underwriters of the Hayek Prize.

Manuel Hinds, Benn Steil, & James Grant

MANUEL HINDS is a consultant to international institutions and governments on issues related to the financial system. He has twice served as minister of finance in El Salvador—from 1979 to 1980 and from 1995 to 1999—and was chief adviser to the president of El Salvador on the dollarization of the country in 2000-2001. He was also the Whitney H. Shepardson Fellow at the Council on Foreign Relations from 2004 to 2005. He is the author of *Playing Monopoly with the Devil: Dollarization and Domestic Currencies in Developing Countries* (Yale University Press, 2006). He holds an MA in economics from Northwestern University.

BENN STEIL is a senior fellow and director of international economics at the Council on Foreign Relations. He is the author, along with Robert E. Litan of *Financial Statecraft: The Role of Financial Markets in American Foreign Policy* (Yale University Press, 2008), and editor of the journal *International Finance*. From 1992 to 1998 he was director of the International Economics Programme at the Royal Institute of International Affairs. He received his MPhil and DPhil in economics from the University of Oxford. He also holds a BSc in economics from the Wharton School of the University of Pennsylvania.

JAMES GRANT founded *Grant's Interest Rate Observer* in 1983. He is the author of five books on finance and financial history, including *Bernard M. Baruch: The Adventures of a Wall Street Legend* (Simon & Schuster, 1983), *Money of the Mind* (Farrar, Straus & Giroux, 1992), *Minding Mr. Market* (Farrar, Straus & Giroux, 1993), *The Trouble with Prosperity* (Times Books, 1996), and *Mr. Market Miscalculates* (Axios Press, 2008). A sixth book, *John Adams: Party of One*, a biography of the second president of the United States, was published in March 2005 by Farrar, Straus & Giroux.

Introduction

by JAMES GRANT

Good evening, Hayekians, Manhattanites, and Brooklynites. We are here this evening to honor a pair of very prescient and scholarly authors. It's an astounding thing, but Manuel Hinds and Benn Steil write economics in English. This is a violation of an ancient canon, but they bear up under the obloquy they have incurred manfully. They write of the dollar's dual mandate. As you know, the dollar is the world's currency, but the Federal Reserve is America's central bank. In that tension, the two of them have written a truly wonderful book about our contemporary monetary fix.

Who are these visionary and literate economists—seemingly a contradiction in terms? Manuel Hinds is the author of *Playing Monopoly with the Devil*, which is the most descriptive title of a monetary tract I've heard in years. It's about the dollar and dollarization. He speaks with practical knowledge, having supervised the dollarization of the El Salvador economy. Many economists are cloistered creatures. Not Manuel. He has been in the thick of coups and revolutions and civil wars and monetary controversies, and come out of it in one, shining piece, thanks to his wife Patricia.

As for Benn Steil, the father of Ethan, he is a senior fellow and director of international economics at the Council on Foreign Relations. Benn is the founding editor of *International Finance* and the author of a previous book, *Financial Statecraft*. However, his highest accolade comes from the University of California at Berkley. Brad DeLong has called him a "wing-nut." Benn, being a dignified fellow, couldn't answer. But I will. Nya nya nya boo boo, Brad.

These two authors come to us this evening as messengers of a serious, yet altogether accessible, work on monetary policy and the future of the dollar. Ladies and gentlemen, Benn Steil and Manuel Hinds.

Toward a common-sense currency

by MANUEL HINDS

In the last fifteen years, we've gotten ourselves into a horrendous monetary mess. We have gone from bubble to bubble, and from bust to bust. We have printed money, first to keep the economy going, then to overcome the bursting of the dot.com bubble; then to sustain a "triple bubble" of housing, securitized instruments, and commodities; then to overcome the effects of the bursting of these bubbles, which has led to a second commodity bubble and an emerging-markets boom that is just waiting to go bust.

It has been a sobering experience, and we should not let it go without answering three questions. First, how did we get into this mess? Second, what can we do to get out of it? Third, how could we avoid getting into this kind of mess again?

How did we get into this mess?

The short answer is: a false promise. We started the twentieth century with the gold standard, a global monetary system that met the common citizen's idea that a currency should keep its value through time and space. This was true nationally and internationally. The global underlying currency was gold and national currencies were backed up by a promise to deliver fixed amounts of gold to the bearer.

These promises were honored. Central banks could print only as much currency as they had gold. There was no inflation to speak of and, even if there were crises, they were sharp but short. After World War I, and throughout the century, governments carried out successive systemic reforms, which continued to water down the linkage between currencies and gold.

The collapse of the Bretton Woods system in 1971 left in place the floating-currencies system, which grants central bankers total freedom to print money at will. Floating currencies won the day because they conveyed a promise that, by allowing total freedom to create money in each country, they would promote global progress and employment, smooth out business cycles, and prevent bubbles and their associated crises. These expectations were based on what we can call the one-dimensionality of macroeconomic theory—the idea that demand is a homogeneous quantity which affects all sectors in the same proportion. Under this assumption, recessions come about because demand declines, negatively affecting the sales of all sectors in approximately the same proportion. This leaves all sectors with unsold inventories, impairing their ability to service their debts.

If the world were actually like this, printing money would be like pressing the gas pedal of an automobile. It would increase demand equally for all sectors, which then would sell all their excess inventories, pay their debts, and start growing again. But in reality, the world is not like this. Printing money is like pressing a gas pedal that accelerates some wheels more than others. When the pedal is pressed to the floor, these disparate forces deform the vehicle. The problem of recessions is precisely this deformation. A deformed economy easily skids.

These deformities initially take the form of bubbles, which increase demand for certain assets—say, dot.com shares, or houses, or commodities—leading to higher prices not in the entire economy but only in these particular assets. People overinvest in these sectors and feel increasingly richer while the boom is raging, generating a consumption binge that spreads the illusory gains of the boom to everybody else in the economy.

Then, the bubble bursts and demand for the booming assets collapses along with prices. Demand does not contract uniformly, but in a distorted way. It contracts in a pattern dictated by the realities and feelings of people who have become poorer overnight. The last thing these people want is to continue buying the previously booming assets. So, the consumption binge comes to a stop. The economy seizes up because the troubled assets cannot be sold at their post-boom prices without defaulting on the loans that burden them. Banks stop lending because they don't know who is solvent and who is not. Thus, at the end of a boom and bust cycle, the economy gets deformed twice.

During a recovery, the volume, shape and structure of demand readjust to each other. Injecting money does not help because it cannot change the composition of demand to get the formerly booming assets booming again.

That's how we got into this mess—by printing money. Now let's move on to the second question. What can we do to get out of it?

In the nineteenth century, markets used bankruptcy to get out of recession. Bankruptcy extinguished obligations that creditors could not collect, liberating troubled assets to be sold at whatever price they could command. The assets became useful again. Loss-making activities and firms ceased to exist, liberating resources for economic growth. While painful, the market procedure led to rapid recoveries.

Today, as during the Great Depression, society has refused to allow the market to follow its course. It has given politicians the power to manage the allocation of losses, hoping that they will revert to profitability. This they cannot do.

Yet, politicians can, and do, use money creation to delay the resolution of a crisis. By subsidizing and directing cash to insolvent debtors, they allow these actors to survive without taking their losses (which is to say, without selling their overvalued assets). In this way, they prevent asset prices from coming down to market-clearing levels. Logically, asset markets do not clear. Then, impaired assets are not used productively. Resources keep flowing toward loss makers. The economy does not recover. And, as the Fed keeps printing money, the seeds are sown for yet another destructive boom-and-bust in commodities and emerging market assets.

To illustrate what is needed to get out of this cycle, imagine you are in charge of cleaning a poisoned pool—poisoned, that is, by bad loans and unused assets. The logical procedure would be to empty the pool, wash it and then refill it. The government has chosen to inject more water into the still poisoned pool, which only dilutes the poison. The amount of water that the government must "spend" to clean the pool in this way is comparatively much larger than if it was simply emptied, washed, and refilled. It takes more time as well.

Just injecting water is even more costly because large sectors in the economy stop trying to get out of the crisis by improving their productivity. Rather, they try to do it by getting ahead in the distribution of government largesse. This rent seeking, the mark of an economy managed politically, is the road to backwardness. To get out of the disarray we find ourselves in, we should cease injecting liquidity and start cleaning the pool.

Now, let's look at the third question. How can we avoid this kind of mess in the future?

The huge costs of unbridled monetary expansion should force a reevaluation of the decisions that led to the shift from a common-sense currency to a central banker's system, in which all values are flexible and resources flow in non-transparent ways from the past to the future and from one place to another. This environment breeds not just uncertainty but also, and most damagingly, rent-seeking behavior—an unhealthy dependence on government that stands in contrast to the principles that breed liberty, wealth, and social progress. In the long run, money creation becomes a road to serfdom.

We should resist the temptation to fool ourselves by saying that, even if we don't change the monetary system, this time things will be different because central banks will be more prudent. Throughout history, whenever governments can print money, they do it. As Hayek wrote,

> The pressure for more and cheaper money is an ever-present political force which monetary authorities have never been able to resist, unless they were in a position credibly to point to an absolute obstacle which made it impossible for them to meet such demands.[1]

Thus, if we really want to prevent these problems from recurring, we should introduce an absolute, credible obstacle to printing money at will. Adopting rules for monetary creation as strict as those that framed the classical gold standard would attain this objective.

Along these lines, James Grant, who kindly introduced us tonight, recently suggested that the United States should adopt the gold standard and do it

unilaterally. Robert Zoellick, the president of the World Bank, suggested that gold should be included as a standard of value in the new system. These proposals should open a debate about the monetary system that we need in this globalized world that we are bequeathing to our children.

This subject is too large and complex to be discussed in a short lecture. There is a message that I would like to leave you with, however. We should never again make the mistake of believing that competitiveness comes from printing money at will, rather than from freedom, hard work, and innovative thinking. Money should be a standard of value, not a toy of politicians.

Thank you very much to all of you, especially the Manhattan Institute for the honor of this prize and for the opportunity to address this distinguished audience under the name of one of the greatest economists in history.

Endnote

[1] F. A. Hayek, "Choice in Currency," *The Collected Works of F. A. Hayek, Volume 6, Good Money, Part II: The Standard*, Edited by Stephen Kresge, Chicago: The University of Chicago Press, 1999, pp. 115.

Hayek and the Dangers of Monetary Nationalism

by BENN STEIL

Manuel Hinds and I have many, many people to be thankful to tonight, but I'll confine myself here at the podium to thanking the Manhattan Institute for the enormous honor of this Hayek Prize, Tom Smith for his vision and generosity in underwriting the prize, and Jim Grant for his gracious introduction.

I should perhaps, though, extend a supplementary thanks to Mr. Guido Mantega. Mr. Mantega, whose name I did not know until very recently, is the Brazilian finance minister. In declaring that the world was "in the midst of an international currency war," Mr. Mantega graciously created a new and timely backdrop for our book—*Money, Markets and Sovereignty*—and our lectures this evening. Mr. Mantega's dark observations rang true enough to set off alarm bells in national treasuries and central banks around the world. They also brought to life Friedrich Hayek's writings in the 1930s on the destructive rise of what he called "Monetary Nationalism."

Hayek believed that the demise of a credible international medium of exchange, and the rise of independently managed national fiat currencies, continuously fluctuating in value against one another, would inevitably foster massively destabilizing short-term capital flows and a breakdown in international trade relations.

The seeds of this destruction were sown in the aftermath of the first World War, when the United States and others decided to restore the international gold standard in name only. In practice, the newly created Federal Reserve and other national central banks would manage their currencies entirely on a discretionary basis, abandoning the rules of the international monetary system that underlay the rapid integration of the international economy that marked the late nineteenth century.

Let me briefly focus on what this turn toward monetary nationalism meant for the United States and the wider world, and what the parallels are to our current situation.

In contrast to popular mythology, the Fed in the 1920s was not following the dictates of the gold standard. Far from it. The Fed was openly pursuing a policy it called price stabilization. Of course, the idea that the job of a central bank was to stabilize some collection of prices is orthodox today. Yet to stabilize the prices the Fed was targeting in the 1920s (wholesale prices, for which data existed) in the face of enormous downward pressure on such prices from rapid technological advance, the Fed had to "force enormous quantities of bank credit into the economic system as an offsetting factor."[1] Writing three years after the crash, the British economist D.H. Robertson observed that "the great American 'stabilisation' of 1922-1929 was really a vast attempt to de-stabilise the value of money in terms of human effort by means of a colossal programme of investment in buildings, motor car plants, etc. . . . which no human ingenuity could have managed to direct indefinitely on sound and balanced lines."[2] Not even the human ingenuity lodged in the Federal Reserve.

Well, what was the result? Everyone today knows about the stock market boom and subsequent crash in 1929. But few are aware of just how pervasive the credit bubble was. Over the decade to 2007 we witnessed here in the United States "a constructional boom of previously unheard-of dimensions. A real estate boom developed, first in Florida, but soon was transferred to the urban real estate market on a nation-wide scale."[3] But whereas this is an apt description of recent history, I actually took this quote from a book written in 1937, by three economists writing about the mid-1920s.

There was also a critical international dimension to the American credit bubble and crash, which has precise parallels today.

Consider first how the United States and China would interact under a classical gold standard. If the U.S. sent a dollar to China, China would have to redeem that dollar for American gold. A fall in the U.S. gold stock would necessitate a rise in U.S. interest rates, which would reduce credit growth, reduce prices,

and reduce the trade deficit. This is the mechanism by which the gold standard automatically corrected global imbalances.

Compare this with today's actual monetary structure. When the U.S. sends a dollar to China, China immediately returns it in the form of a low interest rate loan. That dollar is then recycled through the U.S. financial system, causing further credit growth and, critically, no countervailing Federal Reserve action.

The bubbles and imbalances that have marked the past decade—as they did the 1920s—are features of a monetary regime which operates in precisely the opposite fashion as the one which operated during the great globalization of the late nineteenth century. America is not, as Fed chairman Ben Bernanke would have it, a passive victim of "a global savings glut." It should not, therefore, be surprising that bubbles continue to emerge in one asset market after another, and will continue to burst with damaging consequences.

To grasp what we are getting ourselves into, consider this analogy.

Imagine you get into the shower, turn on the water, and nothing comes out. You call the plumber. He tells you there's a hole in the pipes, and that it will cost you a thousand dollars to repair it. You tell him just to turn up the water pressure instead.

Sound sensible? Well, this is the logic behind QE2, the Fed's strategy to keep flooding the money pipes until credit starts flowing freely again from banks to businesses.

You wouldn't expect this to work in your shower, and there's little reason to expect it to work in the commercial lending market. The credit transmission mechanism in the United States has been seriously damaged since 2007. There is a hole in the pipes. Small- and medium-sized businesses in this country are dependent on small- and medium-sized banks for access to vital credit, yet too many of these banks remain walking dead, unable to lend because their balance sheets are littered with bad commercial and real estate loans made during the boom years.

The Troubled Asset Relief Program (TARP) was an opportunity to force banks to disgorge bad assets. This would have repaired the credit pipes. Instead, banks

were obliged only to take equity injections from the government, equity they consider politically toxic, and they have therefore been focused on returning it at the earliest opportunity—not on using it to boost lending. The net result is that, even though the Fed has driven its short-term lending rate down to zero, most banks will only lend on vastly greater collateral and at much higher real interest rates than before the bust. So now we plow on with the cheap option: flood the pipes and see what comes out.

Make no mistake, something will come out. We've already seen the liquidity intended to boost domestic bank lending instead spill out through the cracks into markets as diverse as agricultural commodities, metals, and poor country debt.

What is remarkable about this is that some of QE2's most prominent cheerleaders actually think it is all well and good wherever new demand shows up. After all, it is only "aggregate demand" that matters to the Keynesian faithful. To worry about the composition of demand, like a Hayekian, is silly. It only complicates the algebra. Nobel economist and *New York Times* columnist Paul Krugman, who today berates the Fed for not opening the sluice far wider, in August 2001 wrote that "The driving force behind the current slowdown is a plunge in business investment." Yet "to reflate the economy," he told us, "the Fed doesn't have to restore business investment; any kind of increase in demand will do." In particular, he continued, "Housing, which is highly sensitive to interest rates, could help lead a recovery." A year later, the Fed having not moved aggressively enough for him, Krugman divined that "[the Fed] needs soaring household spending to offset moribund business investment. And to do that [it] needs to create a housing bubble to replace the Nasdaq bubble." Wish granted.

It is the great seduction of Keynesianism that its economics consists merely in the government's manipulation of national aggregates, and that the flagging animal spirits of the inscrutable entrepreneur need only be compensated for, quickly and painlessly, by government money-printing and spending. But we cannot afford a sequel to the crisis we are only just now unsteadily emerging from. The outside world, which relies on the U.S. dollar as its primary trade vehicle and therefore reserve asset, cannot be expected to watch passively as dollars continue to spew

forth into their currency, commodity, and asset markets, with no clear end in sight. The idea that freely floating exchange rates will take care of everything is contradicted by the post-1971 history of recurrent international financial crises, which compares abominably with the pre-1914 era of the classical gold standard. And it was Hayek who observed in the 1930s that floating exchange rates combined with monetary nationalism was a recipe for trade wars and political conflict.

One conviction that Hayek did share with Keynes was the belief that, ultimately, the power of good ideas trumped the power of organized interests, no matter how entrenched such interests were. In *Money, Markets and Sovereignty*, Manuel Hinds and I have tried, in the spirit of Hayek, to capture the good ideas which, over millennia, going back to the great Stoic thinkers of the ancient Hellenistic world, have been essential to creating sound law, sound money, and enduring international cooperation—ideas which underlay what Hayek called "the Great Society." We hope in some small way to encourage a renewed interest in such good ideas.

Endnotes

[1] Phillips, C.A., McManus, T.F., and R.W. Nelson, *Banking and the Business Cycle: A Study of the Great Depression in the United States*, Auburn, The Ludwig von Mises Institute: 2007 [1937]:187.

[2] Robertson, D.H., "How Do We Want Gold to Behave?", in *The International Gold Problem*, Humphrey Milford, London:1932:45.

[3] Phillips et al., op cit (2007 [1937]:81).

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