

How Central Bank Planning Ruins Markets

Backgrounder No. 178

by James Rickards¹

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Global markets today seem irresistible to central bankers with plans for better times. Planning is the central bankers' baleful vanity since, for them, markets are a test tube in which to try out their interventionist theories. Central bankers control the price of money and therefore indirectly influence every market in the world.



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Given this immense power, the ideal central banker would be humble, cautious and deferential to market signals. Instead, modern central bankers are both bold and arrogant in their efforts to bend markets to their will. Top-down central planning — dictating resource allocation and industrial output based on supposedly superior knowledge of needs and wants — is an impulse that has infected political players throughout history.

Markets and Central Economic Planning

The word *market* invokes images of everything from prehistoric trade goods to medieval town fairs to postmodern digital exchanges with nanosecond-speed bids and offers converging in a computational cloud. In essence, *markets are places where buyers and sellers meet* to conduct the sale of goods and services. In the world today, *place* may be an abstracted location, a digital venue; a *meeting* may amount to nothing more than a fleeting connection. But at their core, markets are unchanged since traders swapped amber for ebony on the shores of the Mediterranean during the Bronze Age.

Market Prices Provide Information. Still, markets — whether for tangible commodities like gold or for intangibles such as stocks — have always been about deeper processes than the mere exchange of goods and services. Fundamentally, they are about *information exchange* concerning the price of goods and services. Prices are portable. Once a merchant or trader ascertains a market price, others can use that information to expand or contract output, hire or fire workers, or move to another marketplace with an informational advantage in tow. An exchange of goods and services may be the result of market activity, but price discovery is the market function that allows an exchange to occur in the first place. And if a problem arises in this process, the modern banker chooses intervention over allowing for the market to correct itself.

The impulse toward central planning often springs from the perceived need to solve a problem with a top-down solution. For Russian Communists in 1917, it was the problem of the czar and a feudal society. For Chinese Communists in 1949, it was local corruption and foreign imperialism. For the central planners at central banks today, the problem is deflation and low

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nominal growth. The problems are real, but the top-down solutions are illusory, the product of hubris and false ideologies. Since 2008, markets have become a venue for wealth extraction rather than wealth creation. Markets no longer perform true market functions. In markets today, the dead hands of the academic and the rentier have replaced the invisible hand of the merchant or the entrepreneur.

This critique is not new; it is as old as free markets themselves. Adam Smith, in *The Theory of Moral Sentiments*, a philosophical work from 1759, the dawn of the modern capitalist system, makes the point that no planner can direct a system of arrayed components that are also systems with unique properties beyond the planner's purview. Friedrich Hayek, in his classic 1945 essay "The Use of Knowledge in Society," written almost two hundred years after Adam Smith's work, makes the same argument but with a shift in emphasis. Whereas Smith focused on individuals, Hayek focused on information. This was a reflection of Hayek's perspective on the threshold of the computer age, when models based on systems of equations were beginning to dominate economic science. Of course, Hayek was a champion of individual liberty. He understood that the information he wrote about would ultimately be created at the level of individual autonomous actors within a complex economic system. His point was that no individual, committee or computer program would ever have all the information needed to construct an economic order, even if a model of such order could be devised.²

Manipulated Data Provide False Signals. Charles Goodhart first articulated Goodhart's Law in a 1975 paper published by the Reserve Bank of Australia. What happens when you manipulate markets using price signals that are the output of manipulated markets? This is the question posed by Goodhart's Law. The law is frequently paraphrased along the lines, "When a financial indicator becomes the object of policy, it ceases to function as an indicator." That paraphrase captures the essence of Goodhart's Law, but the original formulation was even more incisive because it included the phrase "for control purposes." (In original form, it reads, "Any observed statistical regularity will tend to collapse once pressure is placed upon it for control purposes.") This phrase emphasized the point that Goodhart was concerned not only with market intervention or manipulation generally but also on a particular kind of top-down effort by central banks to dictate outcomes in complex systems.³

Indeed, central bankers carefully monitor measures of inflation, unemployment, income and other indicators as a basis for policy decisions. Declining unemployment and rising inflation may signal a need to tighten monetary policy, just as falling asset prices may signal a need to provide more monetary ease. Policy makers respond to economic distress by pursuing policies designed to improve the data. After a while, the data themselves may come to reflect not fundamental economic reality but a cosmetically induced policy result. If these data then guide the next dose of policy, the central banker has entered a wilderness of mirrors in which false signals induce policy, which induces more false signals and more policy manipulation and so on, in a feedback loop that diverges further from reality until it crashes against a steel wall of data that cannot easily be manipulated, such as real income and output.

Central Planning Is Impossible. Adam Smith, Friedrich Hayek and Charles Goodhart all concluded that central planning is not merely undesirable or suboptimal; it is *impossible*. Smith, Hayek and Goodhart all make the point that the variety and adaptability of human action in the economic sphere is a quintessential case of computational complexity that exceeds the capacity of man or machine to optimize. This means not that economic systems cannot approach optimality but that optimality *emerges* from economic complexity spontaneously rather than being *imposed* by central banks through policy. Today, central banks, especially the U.S. Federal Reserve, are repeating the blunders of Lenin, Stalin and Mao without the violence, although the violence may come yet through income inequality, social unrest and a confrontation with state power.

The Wealth Effect. A case in point is the so-called wealth effect. The idea is straightforward. Two asset classes — stocks and housing — represent most of the wealth of the American people. The wealth represented by stocks is highly visible; Americans receive their 401(k) account statements monthly, and they can check particular stock prices in real time if they so choose. Housing prices are less transparent, but anecdotal evidence gathered from real estate listings and water-cooler chatter is sufficient for Americans to have a sense of their home values. Advocates of the wealth effect say that when stocks and home prices are going up [see Figure I], Americans feel richer and more prosperous and are willing to save less and spend more.

The wealth effect is one pillar supporting the Fed’s zero-interest-rate policy and profligate money printing since 2008. The transmission channels are easy to follow. If rates are low, more Americans can afford mortgages, which increases home buying, resulting in higher prices for homes. Similarly, with low rates, brokers offer cheap margin loans to clients, which result in more stock buying and higher stock prices.

There are also important substitution effects. All investors like to receive a healthy return on their savings and investments. If bank accounts are paying close to zero, Americans will redirect those funds to stocks and housing in search of higher returns, which feeds on itself, resulting in higher prices for stocks and housing. At a superficial level, the zero-interest-rate and easy-money policies have produced the intended outcomes. Stock prices more than doubled from 2009 to 2014, and housing prices began rebounding sharply in mid-2012. After four years of trying to manipulate asset prices, the Fed appeared to have succeeded by 2014. The wealth was being created, at least on paper, but to what effect?

How Central Bankers Create Asset Bubbles

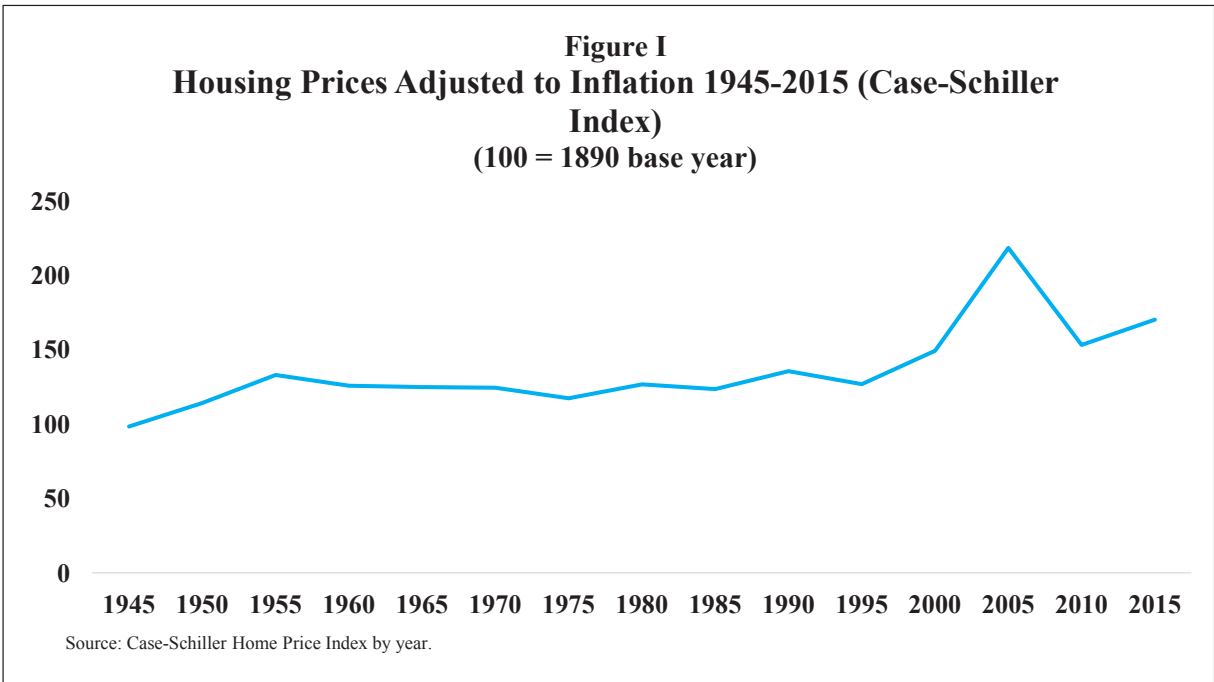
America is today witnessing its third stock bubble, and its second housing bubble, in the past 15 years. When these bubbles burst, the economy will confront a worse panic than occurred in 2008, and the bankers’ cries for bailouts will not be far behind. The hubris of central bankers who do not trust markets, but seek to manipulate them, will be partly to blame.

Exporting Inflation. Asset bubble creation is one of the most visible malignancies caused by Federal Reserve money printing, but there are many others. For example, the United States often exports

inflation to its trading partners through the exchange-rate mechanism — the system of fixing the ratio at which currencies are traded. A persistent conundrum of Fed monetary policy since 2008 has been the absence of inflation in U.S. consumer prices. From 2008 through 2012, the year-over-year increase in the consumer price index averaged just 1.8 percent per year, the lowest for any five-year period since 1965. Fed critics have expected for years that inflation would rise sharply in the United States in response to money printing, albeit with a lag, but the inflation has not yet appeared; indeed persistent deflationary signs began emerging in 2013.

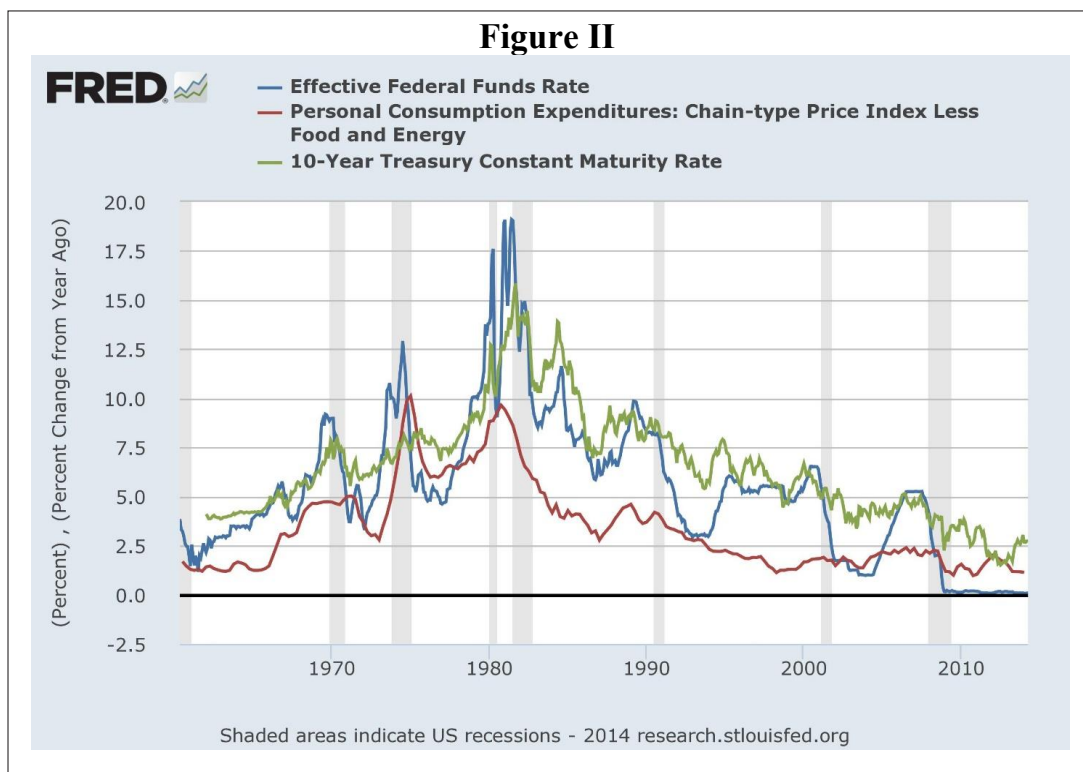
A principal reason for the absence of inflation in the United States is that inflation was exported abroad through the exchange-rate mechanism. Trading partners of the United States, such as China and Brazil, wanted to promote their exports by preventing their currencies from appreciating relative to the U.S. dollar. As the Fed prints dollars, these trading partners must expand their own money supplies to soak up the dollar flood coming into their economies in the form of trade surpluses or investment. These local money-printing policies cause inflation in the trading partner economies. U.S. inflation is muted because Americans import cheap goods from our trading partners.

Federal Reserve Deflation Fighters. From the start of the new millennium, the world in general and the United States in particular have had a natural deflationary bias.



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Figure II



Initially the United States imported this deflation from China in the form of cheap goods produced by abundant labor there, aided by an undervalued currency that caused U.S. dollar prices for Chinese goods to be lower than economic fundamentals dictated. This deflationary bias became pronounced in 2001, when annual U.S. inflation dipped to 1.6 percent, perilously close to outright deflation.

This deflation scare prompted then Fed Chairman Alan Greenspan to sharply lower interest rates:

- In 2002 the average Federal Funds effective rate was 1.67 percent, then the lowest in 44 years.
- In 2003 the average Federal Funds rate was even lower, 1.13 percent, and it remained low through 2004, averaging 1.35 percent for the year.

The extraordinarily low interest-rate policy during this three-year period was designed to fend off deflation, and it worked:

- After the usual lag, the consumer price index rose 2.7 percent in 2004 and 3.4 percent in 2005.
- By 2007, inflation was back over 4 percent, and the Fed Funds rate was over 5 percent.

Greenspan was like the pilot of a crashing plane who pulls the aircraft out of a nosedive just before it

hits the ground, stabilizes the aerodynamics, then regains altitude.

Zero-Rate Interest Policy Leads to Asset Bubbles. Greenspan had fended off the deflation dragon, but in so doing he had created a worse conundrum. His low-rate policy led directly to an asset bubble in housing, which crashed with devastating impact in late 2007, marking the start of a new depression. Within a year, declining asset values, evaporating liquidity and lost confidence produced the Panic of 2008, in which tens of trillions of dollars

in paper wealth disappeared seemingly overnight.

The Federal Reserve chairmanship passed from Alan Greenspan to Ben Bernanke in February 2006, just as the housing calamity was starting to unfold. Bernanke inherited Greenspan's deflation problem, which had never really gone away but had been masked by the 2002 to 2004 easy-money policies. The consumer price index reached an interim peak in July 2008, then fell sharply for the remainder of that year. Annual inflation year over year from 2008 to 2009 actually dropped for the first time since 1955, as illustrated in Figure II. In short, inflation had turned to deflation again.

Deleveraging. This time the cause was not the Chinese, but deleveraging. The housing market collapse in 2007 destroyed the collateral value behind \$1 trillion in subprime and other low-quality mortgages, and trillions of dollars more in derivatives based on those mortgages also collapsed in value. The Panic of 2008 forced financial firms and leveraged investors to sell assets in a disorderly fire sale to pay down debt. Other assets came on the market due to insolvencies such as Bear Stearns, Lehman Brothers and AIG.

The financial panic spread to the real economy as housing starts ground to a halt and construction jobs

disappeared. Unemployment spiked, which was another boost to deflation. Inflation dropped to 1.6 percent in 2010, identical to the 1.6 percent rate that had spooked Greenspan in 2001. Bernanke's response to the looming threat from deflation was even more aggressive than Greenspan's response to the same threat almost a decade earlier. Bernanke lowered the effective Fed Funds rate to close to zero in 2008, where it has remained ever since.

Inflation versus Deflation. The world is witnessing a climactic battle between deflation and inflation. The deflation is endogenous, derived from emerging markets' productivity, demographic shifts and balance sheet deleveraging. The inflation is exogenous, coming from central bank interest-rate policy and money printing. This dynamic has profound implications for policy. It means the Fed cannot stop its easing policy so long as the fundamental deflationary forces are in place. If the Fed relented in its money printing, deflation would quickly dominate the economy, with disastrous consequences for the national debt, government revenue and the banking system. But deflation's root causes are not going away either.

At least a billion more workers will enter the labor force in Asia, Africa and Latin America in coming decades, which will keep downward pressure on costs and prices. Meanwhile a demographic debacle in developed countries will put downward pressure on aggregate demand in these advanced economies. Finally, technological breakthroughs are accelerating and promise higher productivity with cheaper goods and services. The energy revolution in natural gas, shale oil and fracking is another deflationary force.

In short, the world wants to deflate while governments want to inflate. Neither force will relent, so the pressure between them will continue to build. It is just a matter of time before the economy experiences more than just bubbles, but an earthquake in the form of either a deeper depression or higher inflation, as one force rapidly and unexpectedly overwhelms the other.

Unintended Consequences of Federal Reserve Policy

In its desperate effort to fight deflation, the Fed is causing minor meltdowns in markets far removed from the main arena of U.S. government bond interest rates. The unintended and unforeseen consequences of the Fed's

easy-money policies are becoming more visible, costly and problematic in many ways. An overview of these malignancies reveals how the Fed's quixotic pursuit of the deflation dragon is doomed to fail:

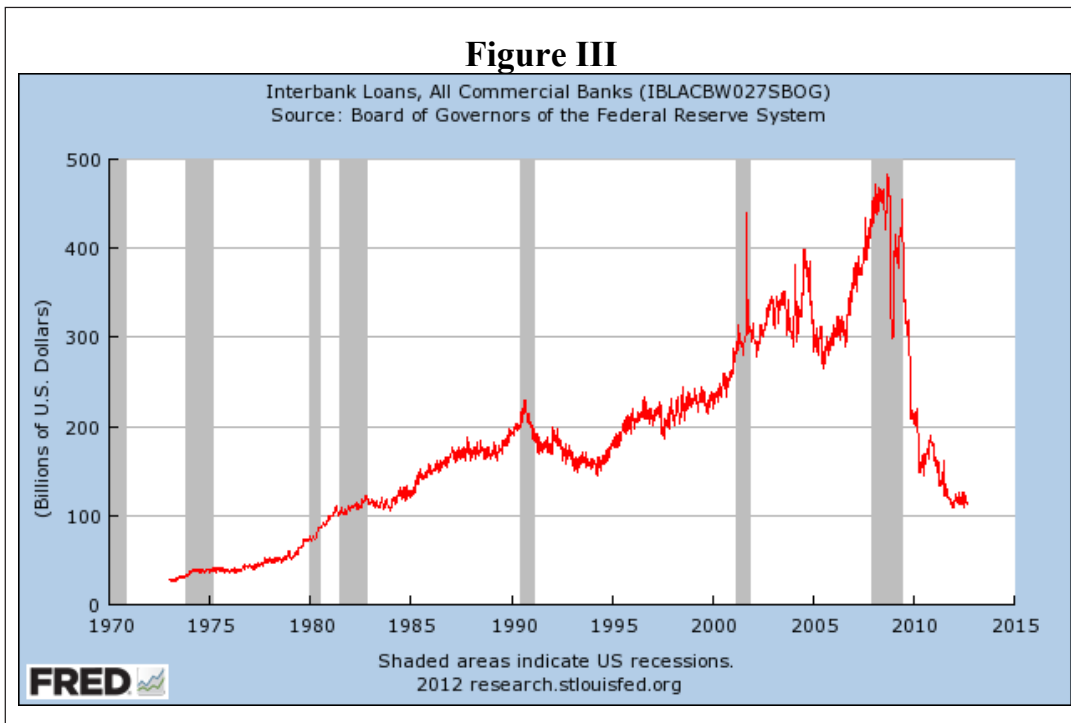
- While inflation was quite low from 2008 to 2013, it was not zero, yet growth in personal income and household income was close to zero.
- This meant that real incomes *declined* even in a low-inflation environment.
- If the Fed had instead allowed deflation, real incomes would have risen even without nominal gains, because consumer goods prices would have been lower.

In this way, deflation is the workingman's bonus because it allows an increase in the living standard even when wages are stagnant. Instead, real incomes declined.

Savers Are Penalized. Another unintended consequence of Fed policy involves the impact on savers. The Federal Reserve's zero-interest-rate policy causes a \$400 billion-per-year wealth transfer from everyday Americans to large banks. This is because a normal interest-rate environment of 2 percent would pay \$400 billion to savers who leave money in the bank. Instead, those savers get nothing, and the benefit goes to banks that can relend the free money on a leveraged basis and make significant profits. Part of the Fed's design is to penalize savers and discourage them from leaving money in the bank, and to encourage them to invest in risky assets, such as stocks and real estate, to prop up collateral values in those markets.

But many savers are inherently conservative and with good reason. An 82-year-old retiree does not want to invest in stocks because she could easily lose 30 percent of her retirement savings when the next bubble bursts. A 22-year-old professional saving for a down payment on his first condo may avoid stocks for the same reason. Both savers hope to get a reasonable return on their bank accounts, but the Fed uses rate policy to ensure that they receive nothing. As a result, many citizens are saving even *more* from retirement checks and paychecks to make up for the lack of a market interest rate. So a Fed manipulation designed to discourage savings actually *increases* savings, on a precautionary basis, to make up for lost interest. This is a behavioral response not taught in textbooks or included in models used by the Fed.

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Small Business Lending Shrivels. Federal Reserve policy has also damaged lending to small and medium size enterprises (SMEs). This does not trouble the Fed, because it favors the interests of large banks. Johns Hopkins University professor Steve Hanke has recently pointed out the reason for this damage to SME lending. [See Figure III.] SME loans, he argues, are funded by banks through interbank lending. In effect, Bank A lends money to Bank B in the interbank market, so that Bank B can fund a loan to a small business. But such lending is unattractive to banks today because the interbank lending rate is zero due to Fed intervention. Since banks cannot earn a market return on such interbank lending, they don't participate in that market. As a result, liquidity in the interbank lending market is low, and banks can no longer be confident they can obtain funds when needed. Banks are therefore reluctant to expand their SME loan portfolios because of uncertain funding.⁴

The resulting credit crunch for SMEs is one reason unemployment remains stubbornly high. Big businesses such as Apple and IBM do not need banks to fund growth; they have no problem funding activities from internal cash resources or the bond markets. But big business does not create new jobs; the job creation comes largely from small business. So when the Fed distorts the interbank lending market by keeping rates too low, it deprives small

business of working capital loans and hurts their ability to fund job creation.

Banks Take on Risk. Other unintended consequences of Fed policy are more opaque and insidious. One such consequence is perilous behavior by banks in search of yield. With interest rates near zero, financial institutions have a difficult time making sufficient returns on equity, and they resort to leverage, the use of debt or derivatives, to increase their returns. Leverage from debt expands a bank's balance sheet and simultaneously increases its capital requirements.

Therefore, financial institutions prefer derivatives strategies using swaps and options to achieve the targeted returns, since derivatives are recorded off balance sheet and do not require as much capital as borrowings.

Counterparties to derivatives trades require high-quality collateral such as Treasury notes to guarantee contractual performance. Often the quality of assets available for these bank collateral pledges is poor. In these circumstances, the bank that wants to do the off-balance-sheet transaction will engage in an "asset swap" with an institutional investor, whereby the bank gives the investor low-rated securities in exchange for highly rated securities such as Treasury notes. The bank promises to reverse the transaction at a later date so the institutional investor can get its Treasury notes back. Once the bank has the Treasury notes, it can pledge them to the derivatives counterparty as "good collateral" and enter into the trade, thus earning high returns off balance sheet with scant capital required. As a result of the asset swap, a two-party trade turns into a three-party trade, with more promises involved, and a more complex web of reciprocal obligations involving banks and nonbank investors.

These machinations work as long as markets stay calm and there is no panic to repossess collateral. But in a liquidity crisis of the kind experienced in 2008, these densely constructed webs of interlocking obligations

quickly freeze up as the demand for “good” collateral instantaneously exceeds the supply and parties scramble to dump all collateral at fire-sale prices to raise cash. As a result of the scramble to seize good collateral, another liquidity-driven panic soon begins, producing tremors in the market.

Stock Markets Boom and Bust. The most alarming consequence of Fed manipulation is the prospect of a stock market crash playing out over a period of a few months or less. This could result from Fed policy based on forecasts that are materially wrong. In fact, the accuracy of Fed forecasts has long been abysmal.

If the Fed underestimates potential growth, then interest rates will be too low, with inflation and negative real interest rates a likely result. Such conditions hurt capital formation and, historically, have produced the worst returns for stocks. Conversely, if the Fed overestimates potential growth, then policy will be too tight, and the economy will go into recession, which hurts corporate profits and causes stocks to decline. In other words, forecasting errors in either direction produce policy errors that will result in a declining stock market. The only condition that is not eventually bad for stocks is if the Fed’s forecast is highly accurate and its policy is correct — which unfortunately is the least likely scenario.

Given high expectations for equities, bank interconnectedness and hidden leverage, any weakness in stock markets can easily cascade into a market crash. This is not certain to happen but is likely based on current conditions and past forecasting errors by the Federal Reserve.⁵

Trading Partners Cheapen Currency. As these illustrations show, the consequences of Federal Reserve market manipulation extend far beyond policy interest rates. Fed policy punishes savings, investment and small business. The resulting unemployment is deflationary, although the Fed is desperately trying to promote inflation. This nascent deflation strengthens the dollar, which then weakens the dollar price of gold and other commodities, making the deflation worse.

Conversely, Fed policies intended to promote inflation in the United States, partly through exchange rates, make deflation worse in the economies of U.S. trading partners such as Japan. These trading partners fight back by cheapening their own currencies. Japan is currently the most prominent example. The Japanese yen crashed 33

percent against the U.S. dollar in an eight-month stretch from mid-September 2012 to mid-May 2013. The cheap yen was intended to increase inflation in Japan through higher import prices for energy. But it also hurt Korean exports from companies such as Samsung and Hyundai that compete with Japanese exports from Sony and Toyota. This caused Korea to cut interest rates to cheapen its currency, and so on around the world, in a blur of rate cuts, money printing, imported inflation and knock-on effects triggered by Fed manipulation of the world’s reserve currency. The result is not effective policy; the result is global confusion.

Regime Uncertainty

Lack of investment was a large contributor to the duration of the Great Depression. Scholars from Milton Friedman and Anna Schwartz to Ben Bernanke have identified monetary policy as a leading cause of the Depression. But far less work has been done on why the Great Depression lasted so long compared to the relatively brief depression of 1920. Charles Kindleberger correctly identified the cause of the protracted nature of the Great Depression as *regime uncertainty*. This theory holds that even when market prices have declined sufficiently to attract investors back into the economy, investors may still refrain because unsteady public policy makes it impossible to calculate returns with any degree of accuracy. Regime uncertainty refers to more than just the usual uncertainty of any business caused by changing consumer preferences, or the more-or-less efficient execution of a business plan. It refers to the added uncertainty caused by activist government policy ostensibly designed to improve conditions that typically makes matters worse.

In the 1930s this uncertainty was caused by the erratic on-again-off-again nature of the Hoover-Roosevelt interventionist policies of price controls, price subsidies, labor laws, gold confiscation and more, exacerbated by Supreme Court decisions that supported certain programs and voided others. Even with huge pools of unused labor and rock-bottom prices, capitalists sat on the sidelines in the 1930s until the policy uncertainty cloud was lifted by duress during the Second World War and finally by tax cuts in 1946. It was only when government got out of the way that the U.S. economy finally escaped the Great Depression.⁶

In the 1970s the U.S. economy was experiencing another episode of extreme regime uncertainty. This

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episode lasted 10 years, beginning with Nixon's 1971 wage and price controls and abandonment of the gold standard, and continuing through Jimmy Carter's 1980 crude oil windfall profits tax.

The same malaise afflicts the U.S. economy today due to regime uncertainty caused by budget battles, health care regulation, tax policy and environmental regulation. The issue is not whether each policy choice is intrinsically good or bad. Most investors can roll with the punches when it comes to bad policy. The core issue is that investors *do not know* which policy will be favored and therefore cannot calculate returns with sufficient clarity to risk capital.

When the Fed says it will raise interest rates upon the occurrence of certain conditions, how certain can investors be that those conditions will ever be satisfied? In trying to remove one type of uncertainty, the Fed merely substitutes a new uncertainty related to its ability to perform the first task. Uncertainty about future policy has been replaced with uncertainty about the reliability of forward guidance. This may be the second derivative of uncertainty, but it is uncertainty nonetheless, made worse by dependence on planners' whims rather than the market's operation.

Conclusion

Adam Smith and Friedrich Hayek warned of the impossibility of the Fed's task and the dangers of attempting it, but Charles Goodhart pointed to a greater danger of centralized control. Even the central planner requires market signals to implement a plan. A Soviet-style clothing commissar who orders that all wool socks be the color green might be interested to know that green is deeply unpopular and the socks will sit on the shelves. The Fed relies on price signals too, particularly those related to inflation, commodity prices, stock prices, unemployment, housing and many other variables.

The more these institutions intervene in markets, the less they know about real economic conditions, and the greater the need to intervene. One form of immeasurable risk, known as Knightian uncertainty, is replaced by another. Regime uncertainty becomes pervasive as capital waits for the return of real markets.

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Notes

1. Adapted with permission from James Rickards, *The Death of Money: The Coming Collapse of the International Monetary System* (N.Y., N.Y.: Penguin, 2014).
2. Friedrich A. Hayek, "The Use of Knowledge in Society," *American Economic Review* 35, No. 4, 1935, pages 519-530. Available at <http://www.econlib.org/library/Essays/hykKnw1.html>.
3. Charles Goodhart, "Problems of Monetary Management: The U.K. Experience," in Anthony Courakis, ed., *Inflation, Depression, and Economic Policy in the West* (Lanham, Md.: Rowman and Littlefield, 1981), pages 111-146.
4. Steve H. Hanke, "The Federal Reserve vs. Small Business," Cato Institute, June 3, 2013. Available at <http://www.cato.org/blog/federal-reserve-vs-small-business-0>.
5. This analysis is based on data and reporting in Buttonwood, "The Real Deal – Low Real Interest Rates Are Usually Bad News for Equity Markets," *Economist*, October 20, 2012. Available at <http://www.economist.com/news/finance-and-economics/21564845-low-real-interest-rates-are-usually-bad-news-equity-markets>.
6. Jason E. Taylor and Richard K. Vedder, "Stimulus by Spending Cuts: Lessons from 1946," Cato Institute, Cato Policy Report, May-June 2010. Available at <http://www.cato.org/policy-report/mayjune-2010/stimulus-spending-cuts-lessons-1946>.