3 Takeaways Podcast Transcript
Lynn Thoman
(https://www.3takeaways.com/)

Ep. 139: The Lords of Easy Money: How the Fed Broke the American Economy, and the Inevitable Pain Ahead

[music]

INTRO male voice: Welcome to the 3 Takeaways Podcast, which features short, memorable conversations with the world's best thinkers, business leaders, writers, politicians, scientists, and other newsmakers. Each episode ends with the three key takeaways that person has learned over their lives and their careers. And now your host and board member of schools at Harvard, Princeton and Columbia, Lynn Thoman.

Lynn Thoman: Hi everyone, it's Lynn Thoman. Welcome to another 3 Takeaways episode. Today I'm excited to be with Chris Leonard. Chris is the author of The Lords of Easy Money: How the Federal Reserve Broke the American Economy, which was named the Wall Street Journal's Best Book of the Year, and is also a New York Times bestseller. If you ask what led to America's financial crashes, no one would say the Federal Reserve or almost no one. The Fed has generally enjoyed the adoration of the press and the public, and it's been credited with the economy's growth. And when the economy has crashed, which it's done every 10 or so years, the Fed has gotten the credit for rescuing us. But Chris will tell the shocking tale of how he believes the Fed broke the American economy and caused the crashes, increased inequality, and even caused the bank failures that we're seeing today. Welcome Chris, and thanks so much for being here today.

Chris Leonard: Thank you for having me.

LT: It is my pleasure. Chris, what is the Fed's superpower?

CL: The Fed's main superpower is it is the only institution in the world that can create new US dollars out of thin air. That thing we call a dollar is actually a Federal Reserve note. And the Fed can create primary or brand new dollars or the monetary base. And in fact, that's why we created the Fed back in 1913 because we realized in America that we needed a government run central bank to both create and manage our currency, because prior to this in America, amazingly in the late 1880s, we had literally thousands of currencies in this country and it was a disaster. Our financial system was characterized by periodic bouts of deflation, bank panics, and we realized we needed an institution to both create and manage the currency or the dollar, and that's what the Fed is.

CL: And that's why the power is so immense because it is at the core of the stability of our currency. So what the Fed does year to year is it creates new dollars or essentially destroys or sucks dollars out of the economy as a way to control both inflation and economic growth. So I think about the people who run the Federal Reserve as kind of being like engineers in the control room of a nuclear power plant. And what they're doing is controlling the heat inside the system, which is the level of new money. And so when the economy is slow or cold, they lower interest rates and create new dollars to stoke growth. But then when growth is moving at a rate that we start to see inflation rise, they cool it down by reducing the monetary supply or sort of destroying the dollars in the monetary base.

LT: How would you describe Fed decisions then? Are they essentially technical decisions made by wise technocrats?

CL: I think this is really a core of the story. When we made the Fed in 1913, Congress was really intentional to keep the Fed out of retail politics to a certain degree. The people who run the Federal Reserve are never elected. The Fed Board of Governors is appointed by the president, approved by the Senate. Other senior officials at the Fed are actually approved by local boards of directors with local bankers on those boards. And the idea was that we would shield the Fed policymakers from the temptations of short-term politics because sometimes the Fed has to do the really hard things to fight inflation. Literally the Fed has to push the economy into a recession sometimes. And when we crafted it, we knew that if the Fed officials were elected, they might focus too much on the short term when they made decisions.

CL: But this has led to this really interesting trend that you just pointed to that I think really started in the Alan Greenspan era when Greenspan became sort of the all-knowing Oracle, the mathematical economic genius who was known as the maestro, because the Fed had been so good at keeping economic growth high while fighting price inflation. And when Greenspan spoke to the public, he was almost humorously open about this. He would say, "If you can understand what I'm saying, then I'm doing it wrong." And what he meant was he spoke in this vernacular that was so complex and so opaque that people started to think that the people who ran the Fed were just these sort of Olympian level PhD economists who were solving equations that were so complicated that normal people probably could never do it.

CL: And that trend has only entrenched itself and intensified over time. But I think it's deceptive. I think in fact the Federal Reserve really is making public policy. It's couched in these complicated economic terms. One of the most important programs I read about is quantitative easing, which that phrase really means nothing to normal people, but in fact what it represents is high scale, fast-paced money creation inside the banking system, which is something people can understand. It's just in the sphere of monetary policy. But when you break it down and describe it in English, people can see that this really is public policy that affects everybody and deeply affects our economy.

LT: Chris, do you believe that the Fed has been responsible for the market crashes and banking crises that America has suffered every 10 or so years? What happened?

CL: Yes, I do think that the Federal Reserve played an incredibly important role in creating those crises. And increasingly over time it played a primary role. Let's go back to the beginning, which was the inflation of the 1970s. Such an interesting economic crisis. So vitally important actually to American economic history. When you look at the inflation, what really gets remembered I think are the long lines at the gas station. The fact that people were having to change the price tag on meat at the grocery store literally by the day. And there were all these complicating factors that seemed responsible for the inflation. Like OPEC created an embargo and raising the price of oil, labor unions bargaining for much higher wages, which caused companies to raise prices. But it was the Federal Reserve itself, and other economic historians like Alan Meltzer, who after decades of really looking back at this period, decided that the Federal Reserve played a critical role.

CL: I mean, the 2004 Federal Reserve study of other studies came to the conclusion that monetary policy was the primary reason for the great inflation. What happened in the late '60s is that the Fed kept interest rates too low for too long, and that's what the Wall Street people call an easy money policy. There were too many dollars being pumped out into the economy for too few goods. You had too many dollars chasing too few goods, which bid up the price of everything from hamburgers to televisions to gasoline. And it was the Fed itself that said monetary policy neglect, or in the late '60s, the Fed's inability to realize that [interest] rates were too low for too long is what stoked the great inflation. So you see this pattern over time of the Fed keeping [interest] rates too low for too long, which makes politicians really happy in the short term, 'cause yay, you know, stock market is up. But it creates these sometimes devastating long-term consequences.

LT: Chris, you believe that that easy monetary policy, that increase with trillions of dollars added to the monetary system and low interest rates, essentially zero interest rates extended from 2008 to today. What kind of behavior did that increase in the money supply and that decade of zero interest rates encourage?

CL: In short, I think the effects have been terribly negative, but they've also been subtle and they play out over the long term. The money that the Fed created and pumped into the banking system was not a neutral force. It benefited some people and it hurt other people and it created a terrible amount of fragility in our economic system. So let me please explain. The Federal Reserve is not like the United States Treasury or Congress, what we call our fiscal authorities. The Fed cannot open a school, teach a student, it cannot put a shovel in somebody's hand, it cannot build a dam. The only way the Fed can really try to stoke economic growth is by pumping all of these trillions of dollars into the banking system on Wall Street. That's where the Fed can create new money, is inside the reserve accounts of the biggest banks like JP Morgan, Wells Fargo, and Goldman Sachs.

CL: According to the Fed's own internal debates, the Fed knew that by doing quantitative easing in the 2010s, it was going to stimulate economic growth by first stoking up asset markets, by pumping up the value of stocks, corporate bonds, real estate, even fine art. The Fed was going to be pumping up these asset prices because the money is flowing into Wall Street and then that means Wall Street has to turn around and find assets to buy with that money. So these banks and hedge funds and private equity firms have all this cash. So they start bidding up the price of assets, these assets, the stocks, the bonds, and all the rest of it. Well, let's just look at who owns assets in the United States. The wealthiest 1% of all the people in the United States own about 40% of the assets in the country. 1% owns 40% of the assets. The bottom 50% of Americans own only 5% of the assets.

CL: So when you have a program that's looking to boost asset prices dramatically, by its nature that is benefiting the top 1%, which is a cliche to talk about, but it really is the richest 1% that own this. So that's why this policy dramatically widened the gap between the wealthiest and everybody else in America. But the second really critical thing it did, was it encourages financial speculation and risky investing. I mean, that really is the whole point of the Fed's actions. It is pushing banks to buy assets or make loans that they would not otherwise make. And what we saw in concrete terms in our economy during the 2010s is that this pushed money into risky investments like corporate junk debt, which has hit record levels, risky hedge fund bets like Treasury futures bets, called a basis risk trade.

CL: These risky hedge fund bets, private equity, buyouts of other firms, money into technology stocks like Tesla, you name it, all the rest of it. The money encouraged speculation into these risky assets which keep their price as long as the Fed never tightens again or never hikes [interest] rates or takes some of that cash out of the banking system. When that happens, these speculative and risky bets, as has happened throughout history, they collapse. And so that's why we're at such a risky point now as the Fed starts to tighten, you see these tech stocks lose a ton of value. We're seeing default rates and corporate junk debts start to increase. It's just like you encourage the speculative risky betting, but eventually the chickens come home to roost and those riskier assets will lose their value.

LT: We recently witnessed the collapse or near collapse of several banks, including SVB, which was the 16th largest bank in the US and Credit Suisse, a global bank based in Switzerland. What do you see as the cause?

CL: The Fed raising rates and tightening very quickly after a decade of extraordinarily easy monetary policy. We've described how that monetary policy has pushed banks to speculate, has flooded banks with cash. Right now, the Fed's balance sheet is just south of $9 trillion, so that's going from $1 trillion to $9 trillion in a decade. Just an extraordinary push into easy money. In 2021, price inflation simply exploded. We had not seen price inflation for many years. It's a really fascinating mystery why we didn't see price inflation, probably had a lot to do with global supply chains. But in 2021, price inflation simply explodes to 9% and the Fed has to slam on the brakes and tighten quickly. Last year, in 2022, the Fed hiked [interest] rates from 1 to 5%, essentially a little bit less than 5%.

CL: That is the fastest rate increase since before even Paul Volcker hiked rates in the early '80s. I mean, the rate of change has been spectacular. It's like slamming on the brakes in the car. You're going 80 miles an hour, you slam on the brakes, you're going to create big effects. The bank failures we are seeing today, inarguably, uncontroversially are a direct consequence of the Fed hiking rates. That's what put Silicon Valley Bank under. That's what exposed Credit Suisse, which had been considered a pretty risk hungry bank. I really do think it's quite significant and people really needed to pay attention to the fact that the Fed hiked rates so quickly in 2022 and we're only three months into 2023 and we've seen regional banks go under and a mega bank in the form of Credit Suisse has already gone under. And we are still in early innings of this process.

LT: So if I asked you to summarize, how do you see the situation now and what do you think the Fed should and should not be doing?

CL: Obviously I've become really critical of the Fed policies of the last decade. I think it was shortsighted policy. I think the experiments were unwarranted and we really need to look back at that, but that's over. That horse is out of the barn and we are where we are today, which is with a highly inflated asset market and a really vulnerable financial system because so much risk has been pushed into the system by the Fed. And in my mind, having looked back at this as normal citizens out here trying to make a living, I think we first of all need to understand inflation really is dangerous and really is bad and needs to be fought. The Fed isn't just doing this on some kind of high principle. Inflation can destabilize our nation really quickly. However, to do that, the process is going to be ugly, really ugly because of these decades of the last [easy money and zero interest rate] policy.

CL: These bank failures we've seen are most likely, if you just look at the effect of higher interest rates and rates having been hiked so quickly, we should expect to see many, many more bank failures. The people I listen to the most and trust the most out there right now are saying that, and I'm not talking about Fed people, but people in private equity, commercial real estate and all the rest of it. So we should expect to see volatile financial responses to these high rates and just know that this is going to be an inevitable part of the process of having higher rates after a decade of ultra easy money. Public policy is where my work ends. I feel like my work is to report and describe, but to figure out how to negotiate this very difficult time is going to be one of the preeminent public policy issues of the next two to three years for sure.

LT: Before I ask for the three takeaways you'd like to leave the audience with today, is there anything else you'd like to mention that you haven't already talked about?

CL: No, look, I'm not a Cassandra by nature and I feel like what I'm saying can come across as criticizing the Fed no matter what they do. They kept rates for too long and that wasn't good, and now they're raising rates and that's not good. What's the central theme? Restraint. And I think the Fed made a huge mistake by pushing outside of its guardrails, by being so aggressive with quantitative easing and 0% interest rates. And so a Fed that exhibits more self discipline that wouldn't have pushed rates so low for so long, would've given itself room to raise rights at a more incremental and slower way now, which could have delivered us from a really intense financial reckoning, which is what we're going through now to go from 0% to 5% [interest rates] in a year.

LT: Chris, what are the three takeaways you'd like to leave the audience with today?

CL: Number one, the Federal Reserve is doing public policy and it's something we should all be talking about and debating. That gets back to your first point. They're not just solving math equations, they're making policy. It affects all of us and creates winners and losers. And I really want to see this debated more broadly. I'd love to see it on Cable News and talked about it in a kind of a rational, constructive way. Number two, critically during the 2010s, the Fed's policies were unprecedented and wildly experimental and we are just seeing the side effects now.

CL: This stuff plays out over the long term and we've really got to understand they broke the rules in the 2010s and we're paying the price. Number three, inflation is dangerous and it should not be underestimated, but fighting it is going to be really painful. So again, from a public policy standpoint, I think we really need to keep the lid on the bubbling pot of inflation. It needs to be fought, but we've also got to have an honest conversation that the consequences are going to be devastating in certain financial markets, which of course is going to affect the rest of us, and we've got to figure out how we're gonna address that.

LT: Chris, this has been fascinating. Your book, The Lords of Easy Money is really eye-opening and thank you so much. This has been great.

CL: Thanks for having me. I appreciate it.

LT: For anyone who's interested, we have several great related episodes. Former Senator Phil Gramm on the Myth of American Inequality, that's episode 124. Former Vice Chair of the Federal Reserve, Alan Blinder on Cryptocurrencies and Soft Landings, that's episode 132. Is This Time Different? Eight centuries of Financial Folly with famed Harvard economist Ken Rogoff, that's episode 114. And How Worried Should We Be About Dysfunctional Government with a constitutional expert who shares how the lawmaking vacuum in Congress has led to a more muscular executive branch and agencies. That's episode 120. Hope you're enjoying 3 Takeaways. See you soon!

OUTRO male voice: If you enjoyed today's episode and would like to receive the show notes or get new fresh weekly episodes, be sure to sign up for our newsletter at https://www.3takeaways.com/ or follow us on Instagram, Twitter, LinkedIn and Facebook. Note that 3Takeaways.com is with the number 3, 3 is not spelled out. See you soon at 3Takeaways.com (https://www.3takeaways.com/)

This transcript was auto-generated. Please forgive any errors.