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INTERVIEW

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ONE MORE THING

EVENTS AND ENGAGEMENTS

Learn more in person from Lara, Murphy, and other Austrian economists, at these upcoming appearances.

ABOUT LARA & MURPHY

L. CARLOS LARA is CEO of United Services and Trust Corporation, a consulting firm specializing in in business advisory services with a primary focus on working with companies in financial crisis. His background in capital formation and business rehabilitation makes him a regular speaker at credit and business conferences.

In 2010 he co-authored the highly acclaimed book, *How Privatized Banking Really Works* with economist Robert P. Murphy.

He is a co-creator of the IBC Practitioner Program for financial professionals and sits on the board of the Nelson Nash Institute.

ROBERT P. MURPHY is Research Assistant Professor with the Free Market Institute at Texas Tech University. He is co-author of *How Privatized Banking Really Works*. He is the author of *Choice: Cooperation, Enterprise, and Human Action* (Independent Institute 2015) and co-host with Tom Woods of the popular podcast Contra Krugman.

Murphy has a Ph.D. in economics from New York University. After spending three years teaching at Hillsdale College, he went into the financial sector working for Laffer Associates. With Nelson Nash, Carlos Lara, and David Stearns, Murphy is co-developer of the IBC Practitioner Program.

LMR Editor in Chief: L. Carlos Lara
LMR Executive Director: Dr. Robert P. Murphy

Managing Editor: Anne B. Lara
Design Director: Stephanie Long

For Information About Advertising and Other Questions,
Contact: rpm@ConsultingByRPM.com

> ***"THE BUSINESS OF BANKING** falls into two distinct branches: the negotiation of credit through the loan of other people's money and the granting of credit through the issue of fiduciary media, i.e. notes and bank balances that are not covered by money."*
>
> *— Ludwig von Mises*

One thing that Mises stressed when considering economic theory in the banking business was to always keep these two activities separate because it was the only way to understand how each function works.

This was also important because modern banking now includes other profitable activities, such as the purchase and sale of securities (which has morphed into what we know as *"investment banking"*), *lockbox banking* (sometimes known as *"factoring"*), and the renting out of safety deposit boxes. Although these areas of banking may be lucrative profit centers, they have no connection to banking proper as Mises has defined it in his statement above.

Loan banking is pretty straightforward and is the granting of credit activity of banks when the bank borrows money from one party at interest and lends it out to another party at interest and profits from the differential in the interest rates charged in the transaction. This activity is recognized as profiting from *"other people's money (OPM)."* The most identifiable banking financial product that performs one side of this function is the bank CD.

But in contrast to loan banking, Mises always placed greater emphasis on *deposit banking.* Here, banks act as negotiators of credit through the issue of *fiduciary media,* which consist of banknotes or bank balances (transferable by check or, in modern times, by debit card) that are not actually covered by money. This type of bank function requires more serious scrutiny and is a bit more complicated to understand so we need to be careful that we don't overcomplicate it for you in getting to its essence and importance for us today.

When banks issue banknotes or (more familiar to us) checkable deposits that can be transferred by check or debit card, these become *money substitutes.* That is, having $1,000 on deposit at Citibank is not *literally* the same thing (legally) as having ten $100 bills in green currency, but in commercial practice—so long as nobody doubts the liquidity of Citibank—just about every merchant in the community treats checking account deposits at Citibank as if they were equivalent to actual green currency. This is why Mises called immediately redeemable checking deposits "money substitutes."

Now the interesting thing about money substitutes is that they perform all of the services of money proper. There is no reason to ever redeem a claim ticket on money, if the community treats the claim itself as just as good as the real money. (In contrast, if you have a claim ticket to a loaf of bread, then you are eventually going to redeem it. You can't eat a claim ticket.) The problem occurred, Mises explained, when bankers *realized* this opportunity to issue more claims on money, than they actually had of money proper in their vaults. Mises used the term *fiduciary media* to identify that portion of money substitutes that were "unbacked" by money proper. Notice that when the banks issue fiduciary media, in an economically meaningful sense they are creating money and, therefore, increasing its supply. This increase of the stock of money (in the broader sense) influences its exchange value, which is a huge distortion. The purchasing power of money falls, and wealth is effectively transferred from all other money-holders into the hands of the bankers (first) and then those who receive the newly-created money early in the process.

Besides weakening the market value of the money (i.e. driving up prices), there is also the more specific problem that newly-created fiduciary media enters the economy through the loan market. In so doing, it pushes interest rates down artificially, giving entrepreneurs the wrong signal, and setting in motion the unsustainable boom.

It is astonishing to Mises, as it is to us in this present day, that this fundamental distinction—namely, the difference between loan banking and deposit banking—received so little attention in the history of political economy. However, once understood by us, we are not far from seeing how the false distortions of economic booms are actually manufactured by tampering with the rate of interest in the process of expanding credit in the economy. Neither do we fail to see the enormous profits it generates for banks and bankers. Profits that have been created because of the public's ignorance in understanding what we hope you, our readers, now see and understand. Thanks for being a part of the 10%!

Yours Truly,

Carlos and Bob

Currency Crises

FIAT MONEY FLOUNDERS

For some time now, the world has watched with pity and alarm as Venezuela's currency collapses. Indeed, the current estimate is that its price inflation rate will break *1 million percent* this year.

But it's not just Venezuela. A recent CNBC headline announces, "Argentina's central bank hikes rates to 60% as the currency collapses." (So far this year, the Argentine peso is down more than 45 percent against the USD.) In Iran, the official central bank announcements say that price inflation over the past year has been a tolerable 10 percent or so, but Prof. Steve Hanke thinks that is a lie (due to currency controls). Using data on the black market exchange rate between the Iranian rial and the USD, Hanke estimates that true price inflation in Iran is probably more than 200 percent.

Turkey has also been in the news. In a situation that reminded investors of the Asian financial crisis of the late 1990s, a public dispute with Trump (regarding tariffs) caused the Turkish lira to plunge, dropping some 40 percent against the USD cumulatively over the year. The specific problem in Turkey is its relatively high amounts of debt denominated in foreign currencies, meaning that as its own currency depreciates against others, it becomes that much more difficult for Turkish debtors to pay their creditors.

These various stories—which are "current events," not being drawn from dusty history books—underscore the importance of Lara's article in this issue of the *LMR*. Thus far, the currency and debt crises have been confined to smaller, less developed economies, but the principles are the same. Yes, the United States is rich and the USD is prestigious, but even so "it can happen here."

PULSE ON THE MARKET

Swiss Stock Spree

SWISS CENTRAL BANK BUYS US STOCKS…TO WEAKEN ITS CURRENCY

To get a sense of just how screwed up the financial world has been since 2008, consider this: Investors are so spooked that the interest rate on deposits with the Swiss Central Bank are *negative* 0.75 percent. That is, investors are willing to put 10,000 Swiss francs on deposit today, in order to have 9,925 francs available next year.

Even so, investors around the world are trying so desperately to get into the Swiss franc (which is considered very safe), that the Swiss National Bank has been creating more and more francs, in order to prevent their currency from rising against the euro. Since their country is so small, they invest some of these excess funds abroad. In fact, as John Mauldin reported back in June in Forbes:

"The SNB [Swiss National Bank] owns about $80 billion in U.S. stocks…and a guesstimated $20 billion or so in European stocks…

They have bought roughly $17 billion worth of U.S. stocks so far this year. And they have no formula; they are just trying to manage their currency.

Think about this for a moment: They have about $10,000 in U.S. stocks on their books for every man, woman, and child in Switzerland…all in the effort to keep a lid on what is still one of the most expensive currencies in the world."

Now to be sure, we are not as trusting (gullible?) as Mauldin when it comes to the motivations of the world's central bankers. Rather than viewing their policies as a sincere attempt to foster recovery according to the Keynesian playbook, we are suspicious that the negative interest rates are *partly* deployed because they justify cracking down on holding cash. (It's hard to maintain a broad-based negative interest rate policy, if people can elect to hold the currency under their mattresses and earn a 0% return.)

Furthermore, one of the most alarming features of central bank policy since the financial crisis is that they now are "allowed" to buy assets beyond mere government debt. There is a huge scope for corruption when a central bank has the ability to invest in mortgage-backed securities and (in the case of the Swiss National Bank) even foreign equities. The central bankers and their allies have certainly not let the 2008 crisis "go to waste" in terms of ramming through policy changes that would have been unthinkable in the pre-2008 world.

NIXING NAFTA?

NEGOTIATORS WRANGLE OVER TRADE PACT

As of this writing, it appears the U.S. has reached an agreement with the Mexican government on revising the North American Free Trade Agreement (NAFTA), which doesn't seem to be a major revamp. (The reaction on Wall Street suggests that Trump officials can claim victory without having changed too much of substance.) However, the Canadian negotiators are still holding out, and Trump's loose lips are not helping with the process.

If and when a new trade agreement for the continent is locked in, we will offer more specific commentary. For now, let us make this modest point: Don't be fooled by the *name* of legislation or a treaty that the politicians give it. The PATRIOT Act wasn't about patriotism, the Social Security Act was neither social nor secure, and NAFTA isn't really a "free trade" deal. If it *were,* it would be an index card saying, "There shall be no tariffs or other trade barriers among these three countries."

To be sure, the particular objections raised by Trump against NAFTA, and his overall worldview when it comes to international trade, are riddled with mercantilist fallacies. Yet we should be careful not to commit the *opposite* mistake, and view these international agreements as emblems of laissez-faire. Genuine libertarian free-traders could plausibly object to NAFTA, the TPP, and other multilateral trade pacts.

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We are pleased to announce that the IBC SEMINAR will be live in Fort Worth, Texas on Saturday, October 13, 2018. *The IBC Seminar is the Nelson Nash Institute's premier Live Event for the public.*

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David Stearns, the President of IBC LLC will open the Seminar and set the stage as Robert P. Murphy, Ph.D economist, and L. Carlos Lara, authors of the books The Case For IBC and How Privatized Banking Really Works present.

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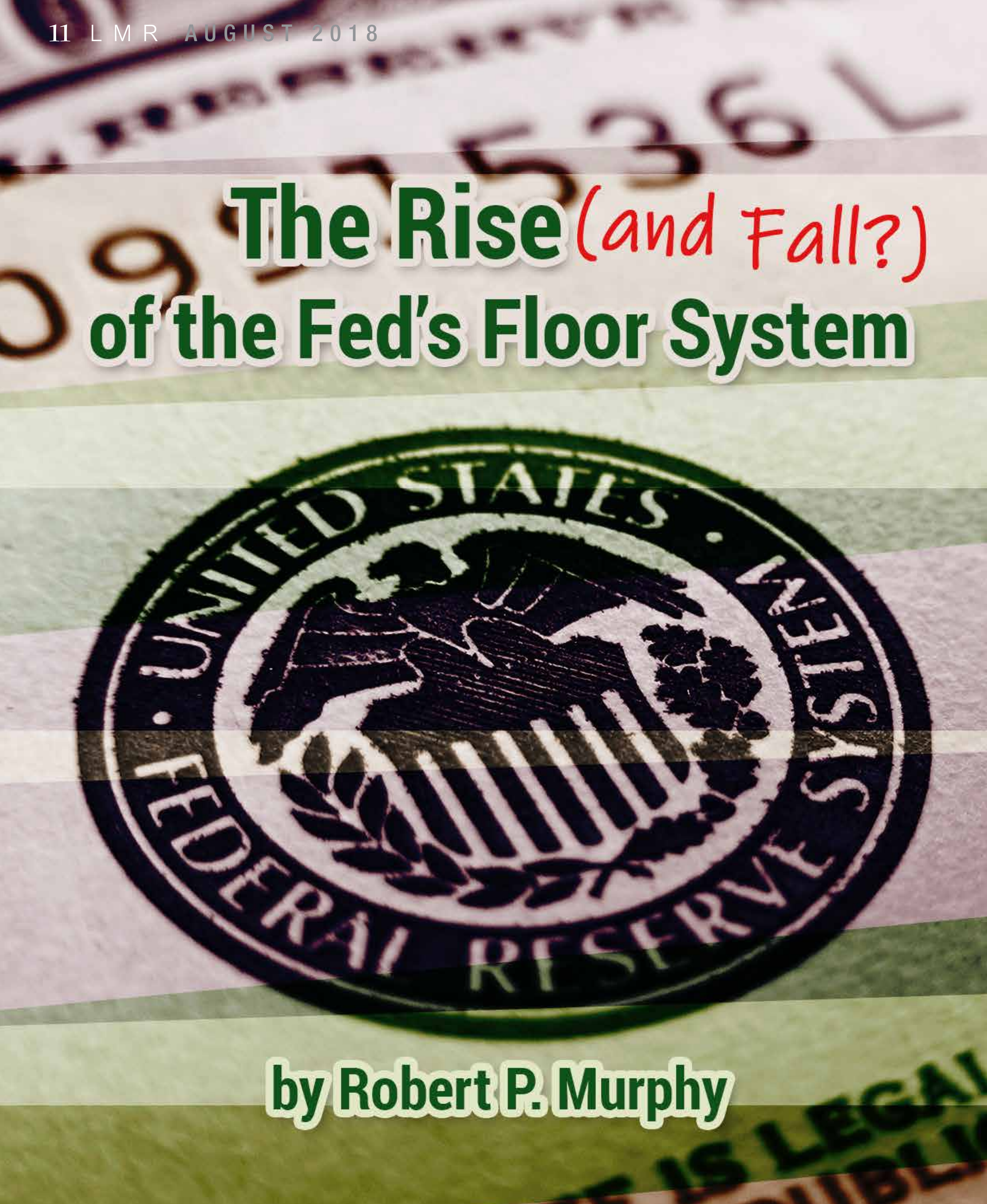


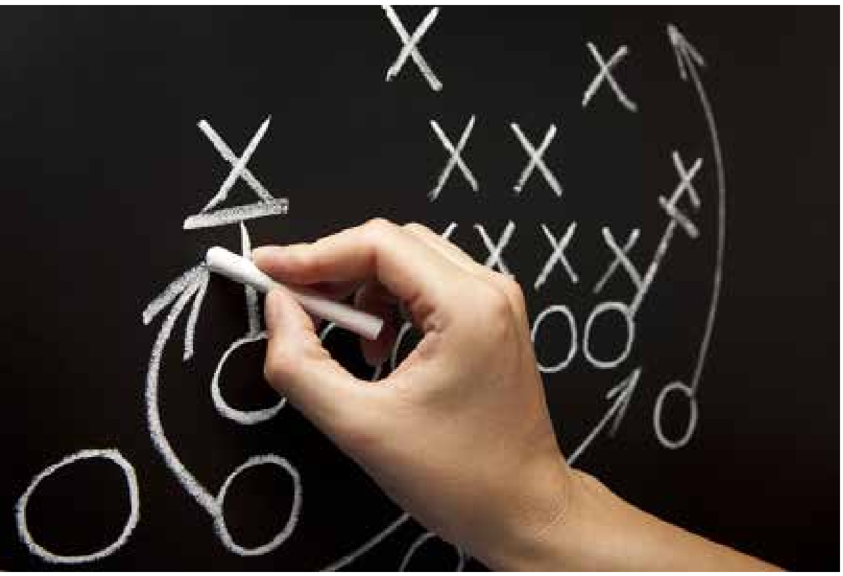
The Rise (and Fall?) of the Fed's Floor System

by Robert P. Murphy

For those who have read our first book (*How Privatized Banking* ***Really*** *Works*) or been to our public seminars, you know that Carlos Lara and I spend a lot of time explaining the mechanics of the Federal Reserve. Specifically, we explain how the Fed manipulates interest rates by expanding and contracting the quantity of money, and then we rely on the work of the Austrian economists to show how these shenanigans with money and banking cause the business cycle.

In this tradition, then, in the present article I want to give our readers an introduction to a change in Fed policy that began soon after the financial crisis. The standard Austrian story is still right, but the specific details are a bit different now, compared to how the Fed conducted operations before the financial crisis.

As we'll see, the way that the Fed sets interest rates has changed, due to a policy shift instituted in October 2008. This change may have affected the timing of the boom-bust cycle, and given the central bank a bit more "breathing room" (which helps explain our long expansion since the recovery officially began). But as even non-Austrian economists are now explaining, the Fed's scope for action is running out. It is being forced to contract credit and raise rates, which is the catalyst that turns a recovery into another crash in the standard Austrian theory.



I want to give our readers an introduction to a change in Fed policy that began soon after the financial crisis. The standard Austrian story is still right, but the specific details are a bit different now.

The Critical Fed Decision in October 2008

The conventional, textbook operation of central banking policy runs like this: When the Fed wants to lower interest rates, it buys assets (typically Treasury securities) in the open market. The act of doing so literally creates new money (electronically), because the Fed effectively writes checks on itself to buy the assets. When the seller of the assets deposits the check into his or her bank account, that bank now has extra deposits parked at the Fed. Nobody else in the economy saw his own bank balance go down because of this transaction; the Fed is allowed to create money "out of thin air." Because there are now more bank reserves in the system, commercial banks are willing to lend those reserves to each other on cheaper terms. The "fed funds rate" (i.e. the interest rate on overnight loans of bank reserves) thus goes down, which is what the Fed wanted to do.

Remember that price inflation had been a growing worry all through the summer of 2008. It's hard to remember now, but crude oil prices had been skyrocketing, topping $147 a barrel in July.

Going the other way—and I'm still reviewing the conventional, textbook description of how a central bank works—if the Fed wants to *raise* interest rates, it sells some of the assets off of its balance sheet. Whatever financial entity in the market buys the assets, has to write a check to acquire them. So that buyer's checking account balance goes down, but the Fed's doesn't go up. Just as the Fed creates new money when it buys assets, it effectively destroys or extinguishes old money when it sells assets. After this operation, there are fewer total bank reserves left in the system, meaning that the equilibrium interest rate charged on overnight loans goes up. Hence, the Fed has achieved its objective of raising interest rates.

So far, so good. Now, what happened after the financial crisis struck in September 2008 is that Fed officials wanted to buy boatloads of financial assets—including not just Treasuries but also mortgage-backed securities (MBS). In addition to bailing out their Wall Street buddies who were caught holding these "toxic assets" by taking them off their books (and moving them onto the Fed's balance sheet), the Fed's large-scale asset purchases would also prop up the prices of these assets and thus stop the panic that was spreading throughout the financial world.

However, remember that price inflation had been a growing worry all through the summer of 2008. It's hard to remember now, but crude oil prices had been skyrocketing, topping $147 a barrel in July. Because of this, the Fed had been cautious in its interest-rate cuts, even though the housing market was clearly in trouble. (Also, though policymak-

Fed officials wanted to have the flexibility of buying billions more in assets, *without* pushing down interest rate.

ers didn't know it at the time, the recession officially began in December 2007.)

For this reason, Fed officials—at least according to their official rationale—wanted to "divorce" their asset purchases from the target for the federal funds rate. In other words, Fed officials wanted to have the flexibility of buying billions more in assets, *without* pushing down interest rates and thereby letting price inflation get out of hand.

The Official Fed Announcement

Consequently, on October 6, 2008, the Federal Reserve announced in a press release[1]:

> ***The Federal Reserve Board on Monday announced that it will begin to pay interest on depository institutions' required and excess reserve balances.*** *The payment of interest on excess reserve balances will* ***give the Federal Reserve greater scope to use its lending programs to address conditions in credit markets while also maintaining the federal funds rate close to the target established*** *by the Federal Open Market Committee.*
>
> *Consistent with this increased scope, the Federal Reserve also announced today additional actions to strengthen its support of term lending markets. Specifically, the Federal Reserve is substantially increasing the size of the Term Auction Facility (TAF) auctions, beginning with today's auction of 84-day funds…* [Federal Reserve press release, bold added.]

(A note for purists: Technically, the Fed began paying interest on both required and excess reserves, and in principle the rates it paid could be different. But we can disregard this subtlety for the purposes of the present article.)

A Perverse Approach

Thus, from October 2008 to the present, the way in which the Fed "sets interest rates" has changed. Rather than buying and selling assets in order to create/destroy reserves in the banking system, instead the Fed uses part of its income in order to *pay commercial banks to keep their reserves parked at the Fed.*

This is really astonishing when you think about it. Remember that Hank Paulson, who was the former CEO of Goldman Sachs but at the time was President Bush's Treasury Secretary, was doing everything in his power that fall to convince the world that we were on the verge of a complete meltdown. That's why we (allegedly) needed the Fed to bail out AIG and the Troubled Asset Relief Program (TARP) to recapitalize major investment banks.

Paulson and Bernanke *hated* to shovel billions into the pockets of their banker friends, gosh darn it, but it was necessary to rescue Wall Street in order to save Main Street. The average American was warned that were it not for the bailouts, his life insurance policy would collapse, his commercial bank wouldn't grant any credit, and his ATM card would stop working.

So in that context, consider just how perverse it was that *at the same time the Fed and Treasury were bailing out the banks in order to "keep liquidity in the system,"* the Fed instituted its new policy that effectively bribed bankers to not make loans to their customers.

***At the same time the Fed and Treasury were bailing out thebanks in order to "keep liquidity in the system,"* the Fed instituted its new policy that effectively bribed bankers to not make loans to their customers.**

The Fed Now Has a Mechanism to Directly Pay Banks

The other thing I'll mention is that this new Fed policy has allowed the Fed to literally write checks to the tune of many *billions of dollars per year* to the banks—both domestic *and* foreign!

Let me quote from a Business Insider article since its author, Wolf Richter,2 made the case so succinctly:

The Federal Reserve's income from operations in 2017 dropped by $11.7 billion to $80.7 billion, the Fed announced today. Its $4.45 trillion of assets…produce a lot of interest income.

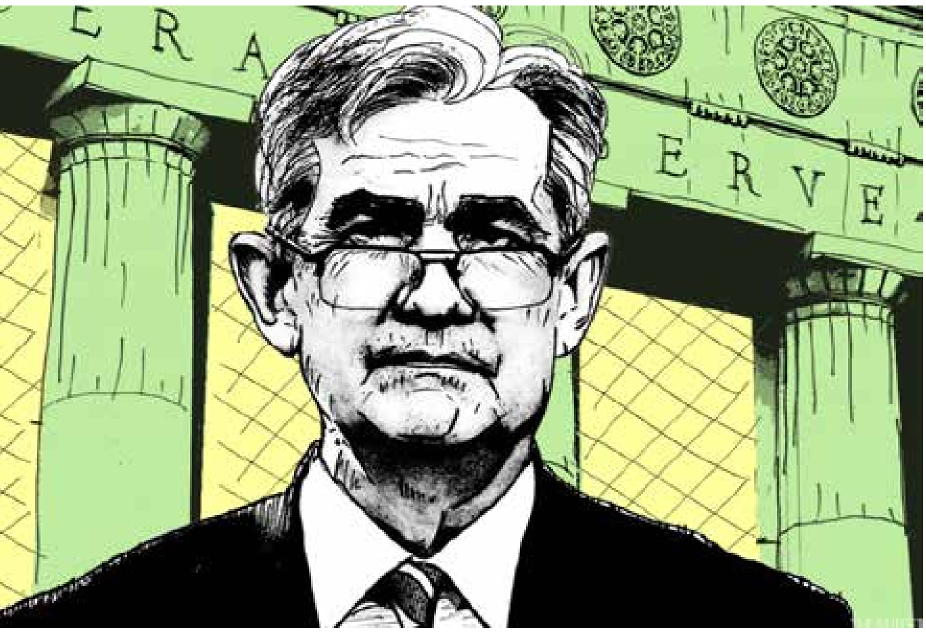
How much interest income? $113.6 billion.

…

When the Federal Open Markets Committee (FOMC) meets to hash out its monetary policy, it also considers what to do with the interest rates that it pays the banks on "Required Reserves" and on

> *"Excess Reserves." In this cycle so far, every time the Fed has raised its target range for the federal funds rate (now between 1.25% and 1.50%) it also raised the interest rates it pays the banks on "required reserves" and on "excess reserves," which went from 0.25% since the Financial Crisis to 1.5% now [i.e. January 2018—RPM].*
>
> …
>
> *So the amount of excess reserves has fallen since 2014. But the interest rate that the Fed pays on them has been ratcheted up since December 2015. And so has the amount that the Fed pays the banks.* ***In 2017, a year with three rate hikes, the interest that the Fed paid the US banks and foreign banks doing business in the US jumped by $13.8 billion to $25.9 billion.***
>
> *That $25.9 billion is the easiest, most risk-free, sit-on-your-a** profit that banks ever made in the history of mankind. [Wolf Richter, bold added.]*

As the Fed continues to hike rates—relying on the floor system, rather than traditional Open Market operations—the amount it pays the banks will also rise, so long as the rate hikes occur faster than the Fed shrinks its balance sheet (and thereby sucks reserves away from the banks).



This is how the Fed has been able to raise its target for the fed funds rate *without* massively unloading the Treasury securities and MBS that it acquired during the multiple rounds of QE following the crisis.

How the Floor System Works

For the rest of this article, I'm drawing on an online article by economist David Beckworth,[3] who is very familiar with the Austrian School but considers himself a "market monetarist." In his recent piece, Beckworth explains how the floor system has worked since 2008, but also that it may be running out of steam. (Incidentally, Beckworth himself relies partially on the work of economist George Selgin[4] while making his case.)

The basic idea behind the floor system is this: For those financial institutions that are eligible to receive the Fed's payment on reserves, it would be foolish to lend out their reserves for anything *less* than what the Fed is offering. That's why the Fed's interest on reserves policy is a "floor": it sets a minimum below which the fed funds rate won't sink.

This is how the Fed has been able to raise its target for the fed funds rate *without* massively unloading the Treasury securities and MBS that it acquired during the multiple rounds of QE following the crisis. The Fed simply increases the rate of interest that it pays to the banks to keep their reserves parked at the Fed (rather than lending them out to customers in the form of new loans), and that ensures that the banks will charge at least as much when they borrow and lend those reserves among themselves. Because the Fed can create money legally, it is the safest borrower around.

Why the Floor System May Be Breaking Down

Now that we've explained how we got here, I want to reproduce two key graphs from Beckworth's post. First, he plots three key interest rates: (a) interest on excess reserves (IOER) which is blue, (b) the one-month Treasury rate which is red, and (c) the overnight London interbank offered rate (LIBOR) which is black:

Figure 1. Three Key Interest Rates, 2009 - 2018

Source: Reproduced from Beckworth (2018) blog post.

At first, this graph might puzzle you. If the Fed is setting a "floor" with its interest rate on excess reserves, then why is the blue line *higher* than the black and red lines in the chart? In other words, why is the market rate of return on 1-month Treasuries *lower* than what the Fed is paying the banks to keep their reserves parked at the Fed?

The answer is that only certain financial institutions are eligible for the Fed program. In other words, *you* can't park money at the Fed and earn the current guaranteed return of 1.95 percent. Only certain qualified institutions can do that.

Since the global economy is still a mess, investors around the world are willing to lend money to the U.S. Treasury in exchange for less than what the Fed has been paying the bankers. That's why the actual return on one-month Treasuries has been consistently *below* the rate paid on excess reserves for the last nine years.

However, as the economy has somewhat recovered, *and* as the federal government has racked up enormous new amounts of debt, the market yield on Treasuries has been rising. (See how the red line has jumped.)

This rise in market interest rates has forced the Fed's hand. Had the Fed kept its IOER rate at the original level of a paltry 0.25 percent, then the banks would eventually have taken all of their excess reserves out of the Fed and loaned them out to customers, or simply used the reserves to buy one-month Treasuries which are also extremely safe.

Therefore, in order to "keep a lid on" the system as it's evolved since the QE programs, the Fed needs to keep raising the interest rate it pays on excess reserves to stay ahead of the steadily rising market interest rates.

(A note for purists: I don't want to get sidetracked from my main point, but let me mention that in the aggregate, most of the reserves ultimately stay with the Fed. But at the individual bank level, it will try to unload its reserves if an outside borrower is offering a more attractive rate than the Fed, taking risk into account.)

So as the "spread" narrows between the Fed's rate on excess reserves and (say) the rate on LIBOR or 1-month Treasuries, the Fed is in danger of losing control. If those excess reserves began to be lent out into the hands of the broader public, the effective stock of money would grow, pushing up prices. The Fed would need to start selling off assets to absorb dollars.

Therefore, in order to “keep a lid on” the system as it’s evolved since the QE programs, the Fed needs to keep raising the interest rate it pays on excess reserves to stay ahead of the steadily rising market interest rates. In other words, the Fed wants to keep the “spread” between those different rates positive.

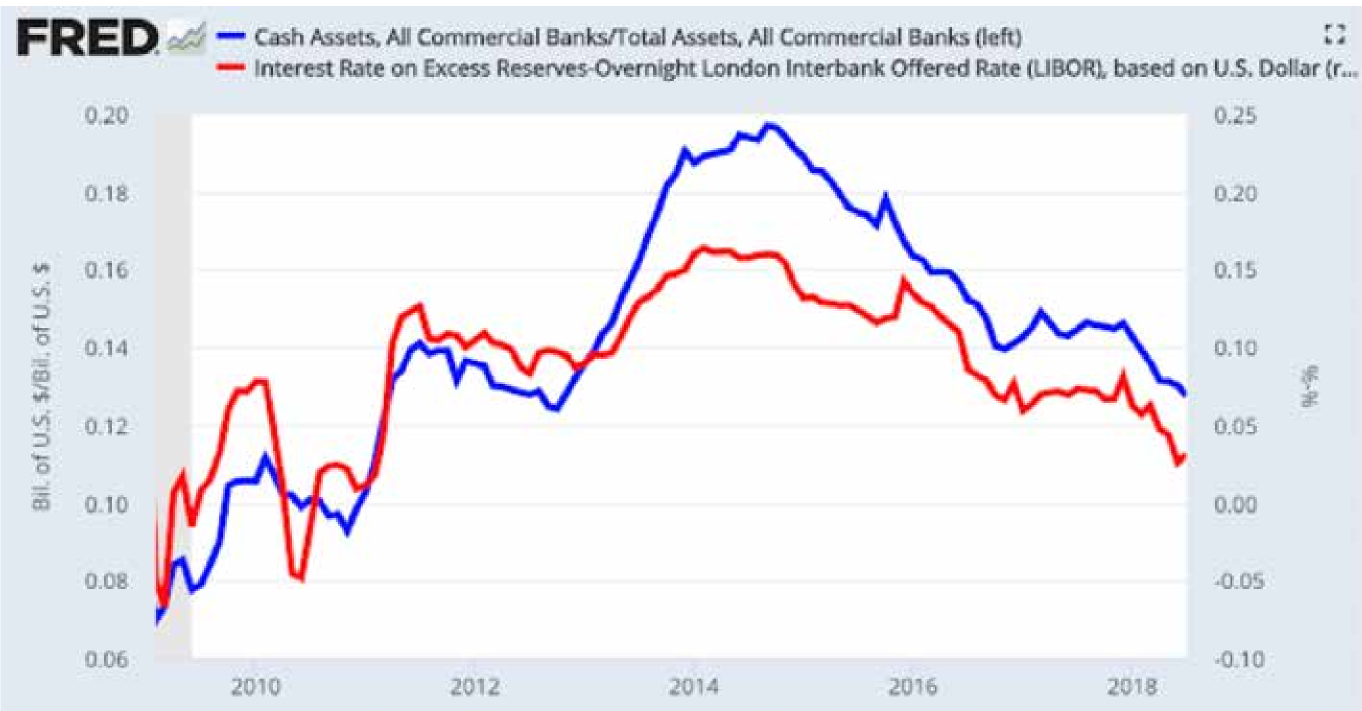
To see how much this spread affects the banks’ lending decisions, consider this fascinating chart from Beckworth:

In Figure 2, we see that as the spread (red line) between the Fed’s interest rate and the LIBOR rate increases—meaning that parking reserves at the Fed is more and more lucrative—then the commercial banks held a larger fraction of their total assets in cash (blue line).

Specifically, in 2009 and early 2010, the spread was close to zero (it even was negative for stretches). If you flip back to Figure 1, you’ll confirm that yes indeed, the IOER and LIBOR rates were close to each other back then, with LIBOR sometimes above the IOER rate.

Yet from 2010 through 2014, Figure 2 shows that the spread widened, up to about

Figure 2. Interest Rate Spread vs. Percentage of Bank Assets Held as Cash



SOURCE: Reproduced from Beckworth (2018) blog post.

16 basis points. (If you flip back to Figure 1, you'll see that the Fed kept its own interest rate floor constant throughout this period. What happened is that the yield on one-month Treasuries and LIBOR fell.)

Now during this same stretch from 2010 through 2014, Figure 2 shows us that the percentage of commercial bank assets held as cash (blue line) rose from about 8 percent up to 19 percent.

Figure 2 shows that the pattern held up going down, too. Specifically, after 2014 the spread began to narrow—i.e. the red line started dropping—and so did the blue line. Bank assets held as cash is now down to about 13 percent.

Here's how Beckworth summarized our current situation:

> *[The] figures suggest that t**he Fed may be already pushing the limits of its floor system.** The banks appear to be shying away from holding so many excess reserves. That change suggests reserve demand is becoming less elastic at this narrowed IOER spread. The floor system may be more fragile than many Fed officials believe it to be.*
>
> ***The only way to ease this pressure on the floor system would be for the Fed to raise the IOER above these other interest rates.** That, though, could lead to an undesirable tightening of monetary policy, putting the Fed in a bind: should the Fed raise rates to keep its floor system intact, at the risk of overtightening? Or should it avoid overtightening at the risk of seeing its operating system come unglued? [Beckworth, bold added.]*

What Beckworth is saying is that the Fed will need to keep raising its own interest rate on excess reserves to maintain an adequate spread above the steadily rising market rates (obtainable on Treasuries for example). However, the Fed may be forced to do so even if the broader economy is not yet strong enough for the rate hikes.

However, the Fed may be forced to do so even if the broader economy is not yet strong enough for the rate hikes.

Conclusion

Carlos Lara and I reject the Keynesian framework according to which an "easy money," low-interest-rate policy provides support for the economy, albeit at the risk of price inflation. On the contrary, Carlos and I subscribe to the Austrian view, which says that artificially low interest rates lead to malinvestments and set the economy up for a crash.

However, even if we look at the world from within the Keynesian paradigm, we can see that the central bankers have painted themselves into a corner. Although the unusual financial conditions since 2008 have allowed them to engage in unprecedented monetary inflation with little apparent effect on regular consumer prices, they have not repealed the laws of (Austrian) economics.

For various technical reasons that I explained in this article, the Fed may very soon be forced to choose: Will it continue to hike rates even though this will lead to a crash, or will it allow its "floor system" to break down such that commercial banks begin lending out the trillions in excess reserves still parked at the Fed?

Neither option is good. If you haven't already watched it, please review our video, "How to Weather the Coming Financial Storms," available at: https://lara-murphy.com/video0916/.

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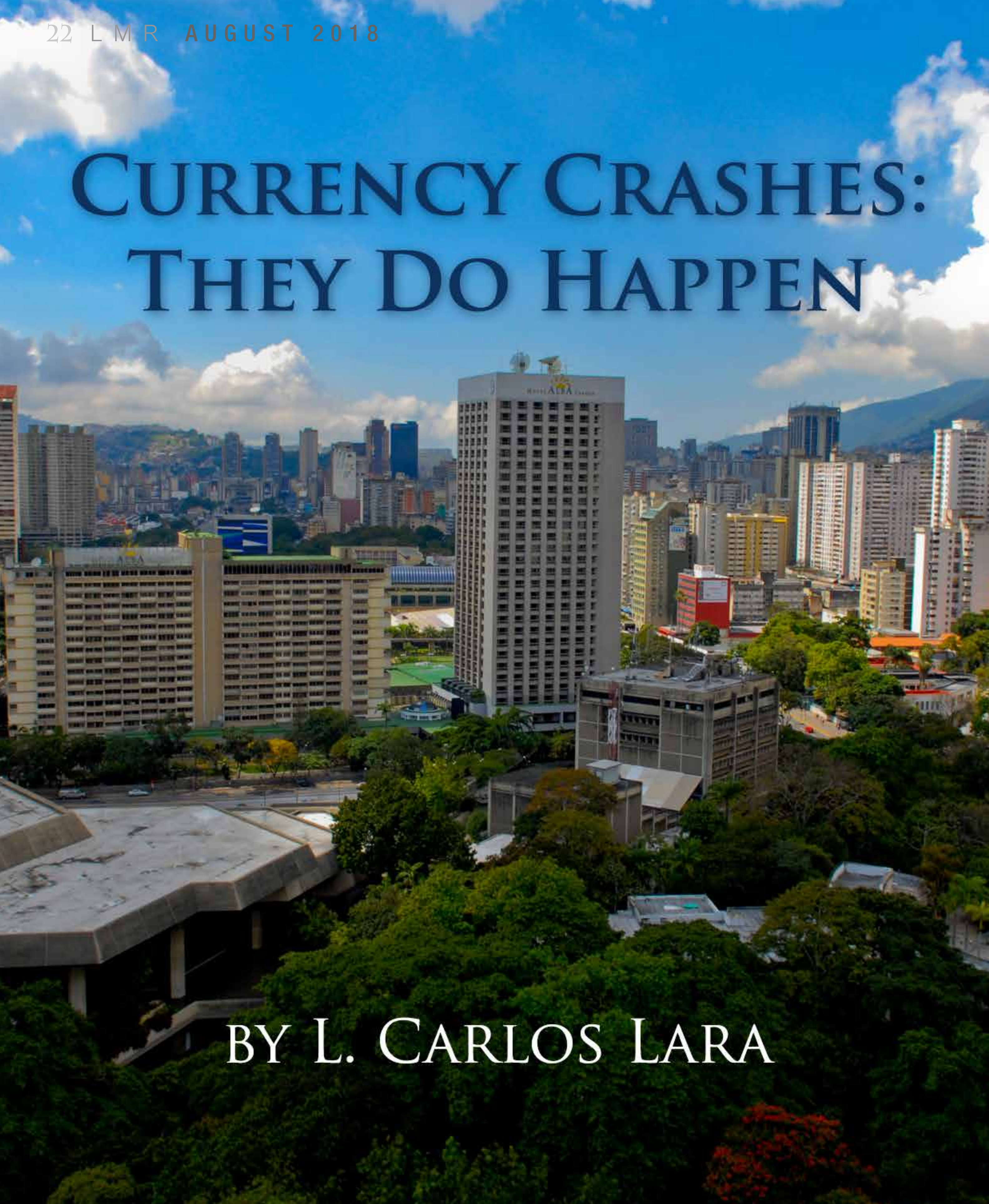
References

1. Federal Reserve press release of October 6, 2008 available at: https://www.federalreserve.gov/monetarypolicy/20081006a.htm.
2. See Wolf Richter, "The Fed paid banks $30 billion on 'excess reserves' for 2017," Business Insider, January 11, 2018, available at: https://www.businessinsider.com/fed-paid-banks-30-billion-on-excess-reserves-for-2017-2018-1.
3. See David Beckworth, "Donald Trump's Real Influence on Fed Policy," Alt-M blog post, August 15, 2018, available at: https://www.alt-m.org/2018/08/15/donald-trumps-real-influence-on-fed-policy/.
4. In the present article I can't devote any space to Selgin's work, but he actually has an entire book coming out on the topic of the Fed's floor system. The interested reader can consult Selgin's archives of articles tagged with "floor system" at this link: https://www.alt-m.org/tag/floor-system/.



Currency Crashes: They Do Happen

by L. Carlos Lara

"Zzzzzzzzzzz. It's the third week in August, so needless to say things are very quiet on the economic front today." [1]

Believe it or not, those were the exact headlines at 6:00 a.m. this Monday morning August 20th on one of the more mainstream and popular international economic news websites. Not only was this unusual to read, but is this even possible for a news agency to claim? Oh, don't get me wrong, their website had plenty of news stories on it, but they

Yes, it may be quiet and peaceful in the U.S., but elsewhere in the world, it's a totally different story.

were all cheerful, exuberant reports of how well the economy is performing. So I can only assume from their headlines that the frequency of broadcasting only happy news on the economy day after day is now causing the news reporters to yawn and even fall asleep.

Yes, it may be quiet and peaceful in the U.S., but elsewhere in the world, it's a totally different story. One glaring example is the disastrous consequences of bad economic monetary policy that is raining down harder than ever on Venezuela and has all but destroyed the once wealthiest country in all South America.

As far as the ***LMR*** is concerned this is one story that should not go unreported by us because while we were all asleep last Friday night, August 17, 2018, Venezuela's President Nicolas Maduro *"carried out one of the greatest currency devaluations in history—a 95 percent plunge,"* [2] to the bolivar, the country's currency, which had become totally worthless. Although this event happened far away in another country there is a relevant message for all of us here in the U.S. that we should not ignore.

In effect, the Venezuelan people woke up to an even more uncertain future that now includes an increase in taxes and gasoline prices to add to the mountain of other economic hardships they have already had to endure for several years now. Many of the

Venezuelans, suffering from malnutrition for lack of food and basic life sustaining necessities, now find themselves in a state of sheer panic just trying to sort out what has just occurred in their country over the weekend.

In a very real sense what we're talking about here is a *currency crash,* the type of thing Bob and I are always warning people about that could actually happen here in the United States, if we don't reverse our country's spendthrift ways. Venezuela's situation

The new bolivar will be linked to a state-owned crypto-currency known as the "Petro" [5] that will fluctuate and is backed by crude oil—a first of its kind technique for a government to ever attempt.

is now so severe that the International Monetary Fund estimates *"its inflation will hit a Weimar Republic-like level of 1 million percent this year, and GDP is in a free fall."* [3]

A New Currency Replaces the Old

What happened over the weekend in Venezuela reminds me of the type of images Bob and I describe in our articles, podcasts, and seminars when explaining what we might expect if our own currency were to collapse. Our descriptions are always consistent. Using history as our guide we explain to people that if a monetary crash were to happen here in this country, the present U.S. regime (or the new regime that comes into power) will quickly move to establish a new currency. What we find is that this is exactly what President Maduro did this past weekend in Venezuela in a desperate act to hold the country together.

Several sources were reporting by the first of the week that the severe devaluation of the bolivar also came with the introduction of brand new paper bills along with a name change—the *"Sovereign Bolivar."* [4] In fact, in order to speed up the distribution process of this new paper money, government bank officials set up kiosks all over the country. But to make things even more perplexing for the desperate economy, the new bolivar will be linked to a state-owned crypto-currency known as the *"Petro"* [5] that will fluctuate and is backed by crude oil—a first of its kind technique for a government to ever attempt.

Actually the new currency measures being adopted seem somewhat logical given that Venezuela has the world's largest proven oil reserve at 300,878 million barrels according to https://www.worldatlas.com/articles/the-world-s-largest-oil-reserves-by-country.html. However, Reuter's doesn't agree that this fact does anything to strengthen this homemade currency strategy and explains why. "Oil output, virtually the country's sole source of foreign exchange, has fallen to 1.5 million barrels per day or lower due to mismanagement at state oil company *Petroleos de Venezuela*."[6] Apparently most sources close to this situation believe the Venezuelan government is completely inept and corrupt. But I am also sure there are several countries looking into this crisis and the wealth that is ripe for picking with greedy eyes.

Bank Closings

As expected, banks closed immediately amidst the weekend turmoil to readjust their systems and ATM machines to the new currency. Of course, all of this is textbook of what typically happens in these types of chaotic scenarios. Most businesses and grocery stores also closed leaving the streets of Caracas, the largest city and capital of the country, looking like a ghost town.

Now the one thing to keep in mind is that Caracas is no small village. This is a major metropolis that is home to over 4 million inhabitants complete with shopping malls, fast food franchises, and skyscrapers much like what we would find in any major city in the U.S. This is what makes this story that much more alarming.

Oddly enough, regardless of the suffering now occurring to millions in this once prosperous nation, there is next to nothing in mainstream news reporting on it. Obviously, it's very distressing information and when things are going so well here in the U.S. why spoil the party with bad news? But these are real world warning signs that we should all heed. Let's not forget that our own economy is itself a shaky edifice propped up by years of artificial stimulus and deficit spending that is simply not sustainable long term. We should not delay in taking precautionary measures to safeguard our households and businesses.

The big uncertainty for Venezuela is whether or not these desperate measures will even work at this juncture. Or is this too little too late for the 31 million people that are virtually trapped in an economic nightmare they cannot escape unless they are able to flee the country? Unfortunately, that option has also become a problem. Both Bloomberg and Reuters report that Ecuador and Peru have already issued immigrant restrictions and Brazil, not its government, but its citizens, have taken matters into their own hands, using physical force to protect their border crossings to keep Venezuelan immigrants from coming in.

Ripe for a New Dictator

The fact that all this happened on a Friday night did not come as a complete surprise to many Venezuelans who remember the events of 1983 when oil prices crashed. A quick fact check explained that the then-President, Luis Herrera Campins, also devalued the bolivar on a Friday night, leading only to further economic upheavals memorializing that day as *Black Friday.* Seems like every country with its economy on the brink has one these dark days and we're no exception, especially for those of us who recall the events of our own Black Monday here in the U.S. on October 19, 1987.

These economic crises that occurred in the 1980s and 1990s in Venezuela led to a political upheaval with massive demonstrations known as the *Caracazo Riots* that killed hundreds and led to Hugo Chavez's rise to power. When Chavez died in 2013, Maduro, hand-picked by Chavez before his death, took over the reins of the country amidst yet another devaluation of the currency due to rising food shortages. "By 2015 Venezuela had the world's highest inflation rate with hundreds of thousands of Venezuelans protesting over high levels of criminal violence, corruption, hyperinflation, and chronic scarcity of basic goods due to policies of the federal government." [7]

Today Maduro is under immense pressure as many in Venezuela are calling for his overthrow. Bloomberg reports a recent near-miss assassination attempt on his life by an aerial drone, which is another indicator of the growing hostility toward him.

Today Maduro is under immense pressure as many in Venezuela are calling for his overthrow. Bloomberg reports a recent near-miss assassination attempt on his life by an aerial drone, which is another indicator of the growing hostility toward him. As a countermeasure, Maduro has turned to the military for support in exchange for full military control of the state-owned oil company and the lucrative business of food imports. In an already immensely corrupt nation this provides the military a golden opportunity to enrich themselves and those closely associated with the state.

Bond Defaults

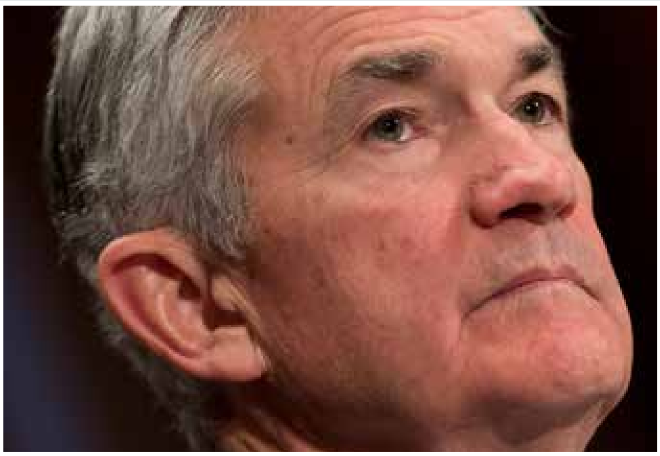
Meanwhile a major cash crunch has set in on Venezuela and Maduro has had to stop making payments on Venezuela's foreign debt of $6.1 billion. Obviously, they are out of money. But this step only causes all credit and new financing from other potential sources to be completely cut-off. What happens next is the seizing of assets by existing creditors in order to cover their losses.

With major oil refineries, such as Conoco/Phillips, Citgo, and others locked into worldwide billion-dollar contracts with Venezuela, the expropriation of assets will only escalate and serve to push the country into a faster death spiral. Maduro's political career and perhaps his own life are vulnerable. Clearly, at this point, we can only expect more bad news to come from Venezuela and more hardship for the Venezuelan citizens. Proof, once again, that bad monetary policy and government intervention not only destroys economies, but also ruins lives.

Bob and I stress the urgency of accumulating a stash of gold or silver in order to be prepared should we experience similar dire measures in the U.S.

Why You Need Gold

A stash of gold or silver coins could easily be traded for U.S. dollars in the *black market*, a market that has existed in Venezuela for years. Actually, individuals and businesses have been going to the black market in order to access dollars because it is the only source that can provide them. But notice that this sort of underground market exchange crops up anywhere in the world when a government defaults. This is one of the main reasons that Bob and I stress the urgency of accumulating a stash of gold or silver in order to be prepared should we experience similar dire measures in the U.S. Although we are not wishing for this kind of trouble to happen to us here in the U.S., it's very prudent to be prepared in case it does. If caught in similar circumstances and we need to buy food or even a plane ticket out of the country, gold and silver can always be traded for such items in the black market anywhere we



Debt is now mounting to staggering levels with hardly a care in the world from our economic and government leaders.

may find ourselves in the world.

Gold, as you know, tends to move up or down based on the strength of the U.S. dollar, but these facts are only important for those who are buying the precious metals as an investment, or for exchange rate purposes. But that is not the advice we are giving you for owning gold or silver. We mean for you to have it at your disposal as emergency money in case the currency of our country fails. (From this perspective, if someone ends up earning a lackluster "rate of return" on his gold holdings over the next 30 years, that will be a *good thing* because it means the authorities got their act together and didn't let the currency crash.) Let's not ever forget that our own currency has failed in the past, not once, but twice. The first time was with the Continentals during this country's infancy and the second was with the *Greenbacks* during the Civil War. So we do not need to be naïve in thinking it can never happen here again.

We need to be realistic about our present circumstances. The great wealth of America has a way of easily distorting our perceptions and can give us a false sense of security. This abundant wealth that we easily see all around us is being systematically squandered. With every passing year, government connected groups steal bigger chunks of it and in doing so add pressure to our already overburdened economic systems. The pressure is compounding.

Debt is now mounting to staggering levels with hardly a care in the world from our economic and government leaders. While our two most emotional markets, stocks and real estate, help drive our prosperous perceptions, we fail to realize that for most of us it's only a paper illusion and it's vulnerable to *"animal spirits"* that can send these markets into a tailspin. These markets do crash. It's inevitable.

Consumer spending, you may have read, is up, but it's because many Americans are feeling rich. Our quarterly tax qualified investment reports assure us of this every time we receive them. Our homes have gone up in value by being swept up by the real estate boom. Also, the new Trump tax cuts add to the euphoria and have given all of us permission to spend beyond our real means.

The Wall Street Journal and Bloomberg both recently cited that Americans are spending like crazy at restaurants. Yet a deeper analysis of the stats reveals that while those sales are growing, customer traffic is actually declining. What's actually happening is that prices have gone up, resulting in higher average dining checks. Point being that the bubbles show up everywhere if you look closely enough.

This is also why you need cash. Having cash handy in a fire proof container will help us survive temporary commercial bank closings that would prevent us from getting access to the money in our bank accounts.

The same thing is occurring with retail sales as companies like Wal-Mart, Lazy-Boy, and Nordstrom posted record earnings last quarter. But looking deeper into that industry what we see is that it is not across the entire retail spectrum. Many brick and mortar outlets like Macy's, J.C. Penney, and others cannot seem to avoid the "retail apocalypse" and are closing stores weekly.

When either the stock market or real estate market eventually crash, these two highly emotional markets will serve to jerk many of us into reality, but there will also be panic. That panic will show itself at the doors of the commercial banks, ushering in an entirely different scenario that you should prepare for.

You Also Need Cash And An 'Alternate' Bank

In the video presentation, *How to Weather the Coming Financial Storms*, https://lara-murphy.com/video0916/ you will learn why it's important to have gold in your possession as emergency money, as well as a stash of *cash* (i.e. actual paper currency) at your immediate disposal. If we don't actually experience a dollar crash we could very well experience systemic bank closings similar to what occurred during the 2008 financial crisis. All this is due to bank runs caused by panicked bank customers immediately after stock and real estate markets crashes.

This is also why you need cash. Having cash handy in a fire proof container will help us survive temporary commercial bank closings that would prevent us from getting access to the money in our bank accounts. A thirty-day supply for bare minimum living expenses should be enough to get us through.

In addition to cash and gold on hand, we also strongly recommend that you set up your very own '*alternate*' banking system using a Whole Life insurance contract from a mutual life insurance company.

Because of these freakish risks problems associated with bank runs and bank closings associated with the 2008 crisis, Congress stepped in and enacted Dodd-Frank as law in 2010. However, make sure you understand that this law primarily assures us that in the future such bank failures will not be handled with taxpayer bailouts. Insolvent and closed banks will now use a new *"bail in"* strategy that proposes bank rehabilitations, but does not necessarily protect the monies we have on deposit in commercial banks. Actually, with further scrutiny some of this law's wording actually creates a bigger problem for all of us as bank depositors and diminishes the protection we thought we had with the FDIC.

Consequently, in addition to cash and gold on hand, we also strongly recommend that you set up your very own *'alternate'* banking system using a Whole Life insurance contract from a mutual life insurance company. This type of cash flow system can actually mimic all of the services provided by the commercial banking system, but with much more protection than is currently offered by commercial banks. To get the full details on this strategy and how to implement it please, if at all possible, make an effort to attend one of our *IBC Seminars.* Our next IBC seminar is being presented at the OMNI HOTEL in Fort Worth, Texas—October 13, 2018. Get all the details here: https://ibcseminar.com/

If you are unable to attend an IBC Seminar in a city near you then you could also read our most recent book, *The Case for IBC,* written by Nelson Nash, Robert Murphy and myself. You can get all the steps and specific instructions on how to set up your own private cash flow system in 100 pages. For full details and instructions on how to pick up a copy of *The Case for IBC* go here: https://thecaseforibc.com/

Whether you manage a household or a multi-million dollar business, you owe it to yourself to be fully prepared for the next big economic crisis because under our current economic environment the next crash will be the biggest one yet.

Conclusion

Many of us have forgotten that a few short months prior to the 2008 financial crisis, most news pundits and even the Federal Reserve Chairman, Ben Bernanke, were talking and bragging about the great performance of the U.S. economy. But as we all now know, it was simply the calm before the great storm.

Today Venezuela is demonstrating in real life what can happen when governments and monetary policy go awry. Market crashes and even currency crashes happen, but we can certainly move toward minimizing being a part of the collateral damage if we act and prepare before the crisis overtakes us.

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The Real History of the Progressive Era

Interview with Patrick Newman

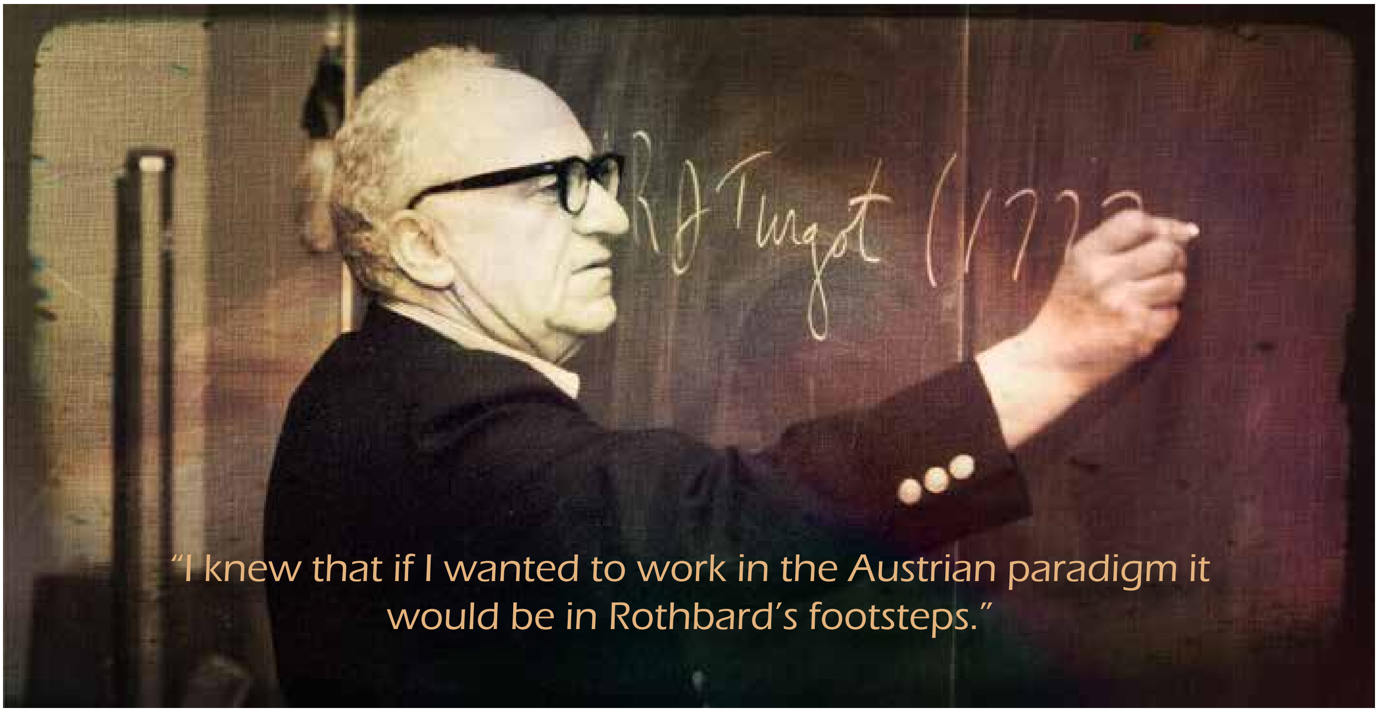
Dr. Patrick Newman is an Assistant Professor of Economics at Florida Southern College and a Fellow of its Center for Free Enterprise. Dr. Newman completed his economics Ph.D. at George Mason University and is an associate scholar of the Ludwig von Mises Institute. His primary research interests include Austrian economics, monetary theory, and late 19th and early 20th century American economic history. He is also the editor of Murray Rothbard's The Progressive Era (2017).

Lara-Murphy Report: How did you become interested in Austrian economics?

Patrick Newman: I became interested in Austrian economics in the fall of 2008 during the financial crisis. I was a senior in high school and I found out about Austrian economics through Ron Paul and his *The Revolution: A Manifesto* (2008). When I read Ron Paul's book everything just seemed to click, he provided a new and revolutionary way of understanding the world to me. What impressed me the most about the book was his economic analysis. I had taken an economics class earlier in high school and found it dull and boring, but after reading Paul's book I found the subject fascinating. In the back of his book he recommended Murray Rothbard's *What Has Government Done to our Money?* (1963) and Mises.org. The rest, as they say, is history. I quickly became a devoted Austrian and libertarian and started to read everything I could get my hands on. By the time I was a sophomore in college at Rutgers University in New Jersey, I knew that I wanted to be an academic and a professor. I attended my first Mises University as a student in the summer of 2011.

LMR: Much of your work has involved researching the evolution of Murray Rothbard's writings. Before we get into some of the specifics (below), can you tell us how you became immersed in the Rothbard archives?

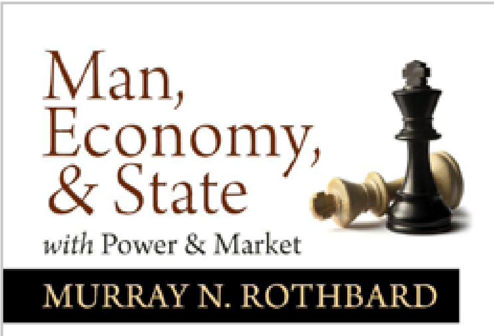
PN: When I started to get involved in Austrian economics the author who I read the most of was Murray Rothbard, followed by Ludwig von Mises. I found Rothbard's economics and history both extremely insightful and entertaining to read. I knew that if I wanted to work in the Austrian paradigm it would be in Rothbard's footsteps. In the summer of 2013 when I was a Mises Summer Fellow, my curiosity got the best of me and I traveled upstairs to the Rothbard archives to see if there was anything interesting that I could write about. The archivist, Barbara Pickard, and I quickly became friends and I started to find all sorts of interesting things.



My first main project involved editing an unpublished chapter of *Man, Economy, and State* (1962). The only way I can describe working in Rothbard's archives is like being a kid in the candy store. You find so much interesting stuff that very few people have seen (sometimes only Rothbard!) and it becomes hard to leave. You want to read more unpublished manuscripts, more correspondences, more letters, etc. I never met Murray Rothbard, but after working in his archives for several years I feel as though I almost know him personally.

LMR: Speaking of this first major project, it was relatively technical. Specifically, you resurrected a previously unpublished chapter (which was originally supposed to be the fifth chapter in *Man, Economy, and State*) on production theory. Can you give us some of the background here, and explain why this material never made it into Rothbard's classic treatise?

PN: The first major project I worked on in the Rothbard archives was editing an unpublished chapter of *Man, Economy, and State* and writing a paper about it. The chapter was on production theory, and both the chapter and my paper were published in the 2015 winter issue of the *Quarterly Journal of Austrian Economics.* (They were also published in a recent collection of essays edited by my colleague Matthew McCaffrey, titled *The Economic Theory of Costs* [2018].)



"His decision to scrap the chapter played a major role in changing the focus of his project away from a textbook rendition of Ludwig von Mises' Human Action (1949) to an entirely new treatise with some new insights of his own."

In his chapter Rothbard developed a much more "neoclassical" theory of production. In particular, he used the theory of perfect competition and the price taker assumption, and developed cost curves that he planned to use for a theory of factor pricing. Overall, his theory focused heavily on the manager of an isolated firm. But as he developed the chapter more, you could tell he was running into tensions. He began to realize that many of these traditional theories have problems, and in the end decided to scrap the entire chapter and start over. His decision to scrap the chapter played a major role in changing the focus of his project away from a textbook rendition of Ludwig von Mises' *Human Action* (1949) to an entirely new treatise with some new insights of his own. The published chapter presents Rothbard's manuscript as he wrote it, while my companion essay describes the evolution of Rothbard's production theory away from a "Marshallian partial equilibrium" to what I call an "Austrian general equilibrium."

LMR: You most recently are the editor of a collection of Rothbard's essays on the Progressive Era. For our readers who only know the 8th grade history version—namely, that big business poisoned customers and chopped off workers' hands for fun, until the feds stepped in—what are some of Rothbard's main points?

PN: During the 1970s Rothbard began to write a book manuscript on the Progressive Era. Although it was unfinished, by the time he stopped working on it he had written chapters on the Interstate Commerce Commission and railroad interventions, the 1897-1901 merger movement and the failure of market monopolies, the end of the 3rd party system and the election of 1896, and the presidential administration of Theodore Roosevelt (1901-1909). *The Progressive Era* (2017) contains this manuscript as well as the later essays Rothbard wrote on the period, which mostly cover topics he did not discuss in the manuscript (such as the welfare state, World War I, and the Federal Reserve). So in a sense, it is roughly a completed book of his analysis on the era.

For most historians and the average citizen (i.e., what they got taught in K-12), the Progressive Era was a very beneficial period in American history. Before, we

"The Progressive Era was a new embodiment of the "Alliance of Throne and Altar"—in this case, big business allied with big government and big intellectuals to push for new laws and regulations that would drive small competitors out of business and increase bureaucratic power."

had unregulated capitalism, and that was a disaster. Consumers purchased poor quality products, the U.S. suffered from rampant business cycles, draconian monopolies drove small and honest producers out of business, and so on. According to this standard narrative, in the Progressive Era well-intentioned and noble reformers (the Paul Krugmans and Elizabeth Warrens of the day) rose up and fought the entrenched interests to institute enlightened government reforms.

Rothbard turns this entire narrative on its head. In reality, the economy was growing after the Civil War and living standards increased. Furthermore, many of the government reforms instituted during the Progressive Era were actually initiated by the entrenched interests the progressives were supposedly fighting. The Progressive Era was a new embodiment of the "Alliance of Throne and Altar"—in this case, big business allied with big government and big intellectuals to push for new laws and regulations that would drive small competitors out of business and increase bureaucratic power. In Rothbard's analysis, it was really the Regressive Era.

LMR: Finally, you have an essay discussing the unflattering origins of the Sherman Antitrust Act. Can you first remind our readers what this legislation was, and then tell us "the rest of the story"?

PN: The 1890 Sherman Antitrust Act was one of the most significant laws in U.S. history. It got the federal government involved in regulating large companies and determining what companies and business practices were monopolistic and "in restraint of trade." The usual narrative presented is that during the 1870s and 1880s, large "trusts" began to dominate the market and engaged in unfair and exploitative business practices that harmed smaller competitors and consumers. In other words, unregulated capitalism was leading to the end of competition and the emergence of monopolies. Coming to the rescue were benevolent politicians and agrarian farmers who rose up and fought the large trusts to get this life-saving law passed.

"Republican politicians and their big business constituents could deflect criticism of the tariff by passing a vague antitrust law (that would not really be enforced) which would supposedly take care of any monopoly problems."

In reality, like most other official versions of history, this narrative is incorrect. Capitalism led to beneficial outcomes and what problems that did occur were actually caused by government intervention. Many large companies were driving small companies out of business, but they were doing this by lowering prices and improving the quality of products. Mass production was displacing small artisanal production. Moreover, many large businesses did actually support the Sherman Antitrust Act, as shown by the fact that it was passed in a Republican-controlled Congress (and Republicans often represented many established big business interests). The first reason is that a more friendly federal antitrust law would blunt the impact of more hostile state antitrust regulations, which were often passed at the behest of small agrarian farmers and had a very anti-big business motivation.

The second reason big business might have supported the Sherman Act is that many large firms were protected by high tariffs. Many Democrats astutely pointed out that these tariffs blocked out foreign competition and led to higher prices than what would have been the case under free trade. Republican politicians and their big business constituents could deflect criticism of the tariff by passing a vague antitrust law (that would not really be enforced) which would supposedly take care of any monopoly problems.

I recently published a paper titled "Revenge: John Sherman, Russell Alger, and the Origins of the Sherman Act" (2018), that explores an additional motivation of Republicans, particularly Senator John Sherman. Rothbard briefly mentioned this motivation in *The Progressive Era* and I elaborate on it. The basic story is that all his life John Sherman desperately wanted to be president. His last real chance at the Republican nomination was in 1888, and going into the convention he was a favorite (this was before the modern primary system).

But in the balloting he didn't perform as strong as expected, and blamed his loss on political newcomer Russell Alger. About a year later, Alger became involved in an antitrust trial involving a company he was tangentially involved in, the Diamond Match Company. Sherman was previously interested in antitrust (most likely for the reasons that all Republicans were), and shortly after he found out about the trial he reintroduced an antitrust bill in the Senate and muscled it out of committee so he could give a speech on the Senate floor. During his speech, Sherman repeatedly mentioned the Diamond Match Company and implied Alger was the head of the company. His main goal was to skewer his rival and imprint in the public's mind that he was involved in a hated monopoly (Alger actually had very little involvement with the company, so Sherman lied), which would prevent him from ever obtaining the Republican nomination in the future. Sherman's tactic worked. The episode is a classic example of how politicians can be motivated by personal vendettas.

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Note: The economists and financial professionals interviewed in the LMR are given the freedom to express their views, without necessarily implying endorsement from the editors.

EVENTS & ENGAGEMENTS

NOTE: MANY OF THESE EVENTS ARE OPEN TO THE PUBLIC. CONTACT US FOR FURTHER DETAILS.

OCTOBER 13, 2018
FORT WORTH, TX

Lara, Murphy, and Stearns present the IBC Seminar for the General Public at the Omni Hotel. For more details and to register, go to: www.ibcseminar.com

OCTOBER 21-28, 2018
US/MEXICO

Murphy joins Tom Woods to host the "Contra Cruise." Details at: www.ContraCruise.com

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