ARC Course on Money Creation **Session Five**

Working Title: **Bad money creation: the statist wrecking ball**

Subject: Money Creation dictated by the government

Theme: Money creation dictated by the government eventually results in unwanted price increases as well as many other adverse economic consequences.

Contrast: Governments and central banks can improve the economy by directing money to their favorite business or voter groups.

[slide - Title]

Lesson Four was titled "Good Money Creation: The Capitalist Money Factory." In contrast to the positive implication of that title, the title of Lesson Five is **"Bad Money Creation: The Statist Wrecking Ball."** The negative implication of that title will soon become clear. Our theme today is that money creation caused by government eventually results in unwanted price increases as well as many other adverse economic consequences.

[Slide- Lesson Five Topics]

In pursuit of this theme we'll cover three topics in Lesson Five:

1. **The real meaning of "inflation"**
2. **The Japanese property bubble of the 1980s**
3. **Quantitative Easing in the USA from 2009 to 2022**

First, we are going to define inflation in a way that will improve our understanding of the entire inflation phenomenon. **I define inflation, not as an increase in prices, but as an increase in the quantity of money caused by government actions,** and I will spend some time justifying that definition.

Next, armed with this definition, we'll examine two important inflationary events from recent history – events that did not involve conspicuous increases in consumer prices and are therefore not even called "inflationary" by most economists.

The first great inflation event is the great **Japanese asset bubble of the 1980s**, culminating in a severe financial crash in 1989 that Japan has still not fully recovered from, almost 35 years later.

The second event is the era of Quantitative Easing, initiated by the U.S. Federal Reserve under Chairman Ben Bernanke in 2009 and lasting until mid-2022. This inflation was unprecedented in its scope, resulting in massive asset price inflation, with many adverse effects that still have not

been fully diagnosed by mainstream financial pundits. This “QE Bubble,” as I call it, culminated in a significant escalation of consumer prices starting in 2021 and is still going on today.

Finally, based on these two case studies, we’ll draw some important general conclusions about the important consequences of money creation caused by government action.

[Note: This manuscript contains a number of “optional” passages which I had no time to discuss in the zoom class.]

TOPIC ONE: THE REAL MEANING OF INFLATION

“Inflation” is widely touted as the number one economic problem of our time, but inflation means different things to different people.

[SLIDE – the OED]

According to my Oxford English Dictionary, the OED, dated 2002, "Inflation" is defined as:

> “(Unduly) great expansion or increase; *spec.* (a) **economics** (undue) increase in the quantity of money circulating, in relation to the goods available for purchase; (b) **popularly** inordinate general rise in prices leading to a fall in the value of money.”

The first definition is fairly close to my own – an excessive increase in the quantity of money – but notice that it is much different from the second “popular” definition – a general rise in prices – which is the definition most contemporary economists have now adopted, even though the OED says the “undue increase in money supply” is the technical definition used in economics.

In recent years, economists at the Fed and other central banks have narrowed this popular definition even further. They now say inflation is not just an unwanted increase in general prices but in “consumer prices,” as measured by their official price index. The Fed uses the PCE index (“personal consumption expenditures”) which is similar to the more well known Consumer Price Index (CPI). For example, if the Fed’s standard price index (the PCE) increases year-over-year by four percent, they will declare that “the inflation rate is four percent” or just “inflation is four percent.”

But does defining inflation in this way further our understanding of the inflation experience?

The purpose of defining any concept is to differentiate it from all other concepts. Differentiation requires identifying the essential characteristics of the concept we are considering. To take the classic example, we define “man” as the “rational animal” because the human rational faculty fundamentally differentiates human beings from all other animals. If we said, “Man is the mammal with an opposing thumb and forefinger,” that might be true, but it would tell us practically nothing about the *essential* difference between a human and an ape.

To illustrate the problem of identifying essentials, what would you think of a doctor whose patient has a fever, and the doctor immediately diagnoses “fever” and promptly plunges the patient into an ice bath, which just might kill the poor patient? Does the diagnosis of “fever” define the patient’s condition in any useful way? What’s the cause of the fever? Is it caused by dehydration, a common cold, or something serious like cancer or a deadly pathogen? What are the patient’s other symptoms? Many diseases are known to raise body temperature, which doctors know is a symptom of a problem more fundamental than an above-average body temperature.

Obviously, any doctor who treated a serious condition this way would be rejected as a quack.

If we define inflation as an increase in consumer prices, then anything that increases consumer prices must be a cause of inflation. We then lose the ability to differentiate between price increases caused by an increase in the quantity of money or by a decrease in the quantity of goods sold. For instance, I can claim that price increases caused by hurricanes or earthquakes, which cause temporary shortages of goods and raise prices in the short term, are an example of “inflation,” and therefore in the same category as a price increase caused by a flood of new money. Obviously, the two are very different. Should both be called inflation?

This kind of muddy definition provides cover for politicians and economists to blame our current inflation on supply chain disruptions related to the Pandemic, or on energy shortages caused by Russia’s invasion of Ukraine. This is convenient, because if they can blame the inflation on some external event, they can disavow responsibility for it. They can also more easily justify rationing or price controls under the guise of “fighting inflation,” as if it is some kind of natural disaster instead of their own making.

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Here's a recent example of an economist from a prestigious investment bank, Morgan Stanley, who is literally blaming “inflation” on a cyclical weather pattern.

"A Headwind For Policy Normalization": Morgan Stanley Adds El Niño To List Of Inflation Risks

BY TYLER DURDEN SUNDAY, SEP 10, 2023 - 10:30 AM

By Seth Carpenter, Global Chief Economist at Morgan Stanley

El Niño most directly affects consumer inflation as food and energy commodities prices pass through. Of late, inflation has been coming down across both developed and emerging markets, with global headline inflation falling to 3.4%Y in June from 3.8%Y in May. July prints also showed further

https://www.zerohedge.com/markets/headwind-policy-normalization-morgan-stanley-adds-el-nino-list-inflation-risks

Morgan Stanley feels this is valid because they define inflation as an increase in consumer prices. Bad weather can can prices of some items to rise temporarily, so El Nino must be inflationary!

Here is what Von Mises said about this “dangerous semantic confusion”:

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A “Deplorable Confusion”

> “There is nowadays a very reprehensible, even dangerous, semantic confusion that makes it extremely difficult for the non-expert to grasp the true state of affairs. **Inflation, as this term was always used everywhere and especially in this country, means increasing the quantity of money and bank notes in circulation and the quantity of bank deposits subject to check. But people today use the term "inflation" to refer to the phenomenon that is an inevitable consequence of inflation, that is the tendency of all prices and wage rates to rise. The result of this deplorable confusion is that there is no term left to signify the cause of this rise in prices and wage**s….. Those who pretend to fight inflation are in fact only fighting what is the inevitable consequence of inflation, rising prices. **Their ventures are doomed to failure because they do not attack the root of the evil.”**
>
> - https://mises.org/library/economic-freedom-and-interventionism/html/p/123
>   *Transcript of remarks before the Conference on the Economics of Mobilization, held at White Sulphur Springs, West Virginia, April 6-8, 1951, under the sponsorship of the University of Chicago Law School.*

I’ve made the case that it’s very misleading to define inflation as an increase in consumer prices, but what is a good definition? The OED says it is an “undue” increase in the quantity of money, which implies “unnecessary” or “unjust.” How do we determine what is “undue”?

In our study of the Cantillon effect, we learned that any increase in the quantity of money will tend to elevate specific prices above what would have occurred in the absence of the increase in money. However, as we saw in Lessons Three and Four, money creation in a free market is self-limited by natural market forces. This means **money creation regulated solely by the market cannot create an “undue” increase in the quantity of money**, at least not for any prolonged period, because the market will self-correct any tendency toward excessive lending.

Unless the government steps in to supply the banks with additional fiat cash reserves when they get into trouble, banks are limited in the amount of money they can create. We are left with the fact that only government intervention in the banking system can enable a prolonged or persistent increase in the quantity of money. This fact leads us to a better, more useful

definition of inflation, developed by George Reisman in his great work *Capitalism*, and which I have adopted as my own preferred definition.

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> "Inflation itself is not rising prices, but an unduly large increase in the quantity of money, caused, almost invariably, by the government. In fact, a good definition of inflation is: *an increase in the quantity of money caused by the government*. A virtually equivalent definition is: an increase in the quantity of money in excess of the rate at which a gold or silver money would increase."
>
> - George Reisman, *Capitalism*, page 219

This is the best, most fundamental definition of inflation I have found, with all credit to Professor Reisman. I also use the term "unproductive money creation," which I believe is approximately equivalent to money creation caused by government. I say this because there can of course be instances of unproductive money creation (i.e., bad loans) in a free market, but these cannot be a *systematic* characteristic of a free-market banking system because of its self-correcting features.

I cannot do full justice to the topic of inflation in this brief course, so I recommend reading Chapter 7 of Professor Reisman's book *Capitalism*, which includes a thorough discussion of inflation, shortages, and price controls.

In addition to unwanted price increases, there are other important consequences of excessive money creation, which we are about to explore with historical examples. **The purpose of this excursion into recent financial history will be to illustrate all the many malignant after-effects of government-caused money creation.** In doing this exercise, we'll be like the good doctor who notices his patient has a temperature – analogous to rising prices – but delves deeper into the cause and discovers many more adverse effects coming from the same fundamental cause, namely unproductive money creation. Focusing only on rising consumer prices would cause you to overlook the importance of some of the major inflationary episodes of recent history, which we are about to discuss.

EXAMPLES OF BAD MONEY CREATION CAUSED BY GOVERNMENT

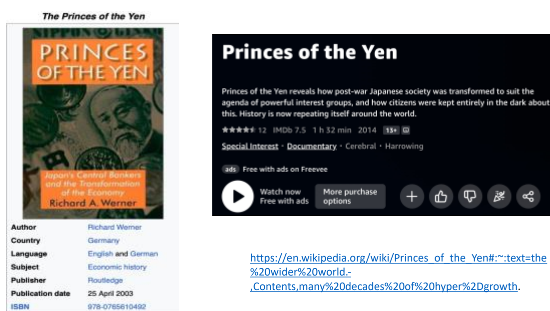
To appreciate the damage that can be done by government decisions to create money, let's examine two prominent, modern examples of asset bubbles that occurred over a long period. As we dive in, remember the Cantillon Effect, remembering that prices will go up at the point where the new money is spent.

TOPIC TWO: THE JAPANESE PROPERTY BUBBLE – LESSONS FROM "PRINCES OF THE YEN"

(as of September 2, 2023)

As our first example of bad money creation, we are going to review the Japanese property and stock market bubble of the 1980s, including what caused it and how it ended.
This is a chart of a price index of 225 largest stocks in the Japanese stock market. The thing to notice is that this market went vertical in the mid-1980s, peaking in late 1989. It then crashed abruptly. This was 34 years ago, and to this day the Japanese stock market has not recovered to that record price level. If you watch stock prices you know this is one of the great asset bubbles in financial history.

[slide – *Princes* reference]



For this analysis, I am relying on Professor Richard Werner's excellent book, *Princes of the Yen*. Prior to and during this asset bubble, Werner was an investment analyst in Asia covering the Japanese market. In the early 1990s, he conducted research inside the Bank of Japan. Werner is a remarkable scholar who speaks and writes fluently in German, English, and Japanese. His book was originally published in Japan in 2003, 14 years after the peak in the Japanese stock market, when Japan was still stuck in a serious economic rut, and no one seemed to understand why.

Princes of the Yen provided the explanation, becoming a national best-seller, and for a while outselling even *Harry Potter*. There is also a very good video of *Princes*, available online, which I will quote several times here.

Summary of "Princes of the Yen" https://www.youtube.com/watch?v=p5Ac7ap_MAY

After World War II, Japan's financial structure was governed by the same financial system that had run its wartime economy. Japan's Ministry of Finance (MOF), roughly equivalent to the U.S. Treasury Department, oversaw fiscal matters, while the Bank of Japan (BOJ), the central bank, took care of monetary policy. By law, the BOJ answered to the MOF for most policy matters, including interest rate targets. MOF engaged in a fair amount of central economic planning by developing industrial policy. This was different from financial governance in the Western nations, which did not engage in a high level of central planning.

Within just a few decades after the war, Japan staged an amazing economic recovery. The BOJ played a key role in the initial recovery by creating enough new cash reserves to buy out the banks' holdings of worthless war bonds, putting the banks on a solid financial footing. So, the basic pre-war financial system was still intact: Japan's system of allocating bank lending to favored industries, which had built a war-fighting machine capable of projecting power around the world, was redirected to a peacetime footing.

During the decades following the war, the BOJ continued its wartime policy of allocating credit to its subsidiary banks, a system known as "window guidance." Under this system, the BOJ gave its member banks quotas for lending, dictating (or strongly encouraging) how much each bank could lend and which economic sectors (steel, autos, chemicals, etc.) should receive the new money. There was some room for flexibility, but the BOJ fundamentally controlled where the new money flowed.

This was the war economy system adapted to the production of consumer goods for export and domestic consumption. **The Japanese wartime money factory (the banks) converted from funding tanks and submarines to financing factories**. A 1951 amnesty on war criminals returned most of the banking bureaucracy to their previous positions, so the system retained its banking expertise.

For the 1950s, 1960s, and most of the 1970s, Japan flourished under this system, as the general quality of life improved rapidly. For example, in 1959 alone, the real economy expanded by 17%, an almost unheard-of rate of real growth, unprecedented (as far as I know) in modern economies. While impressive, this growth was not wholly unexpected for a productive, enterprising population that needed to rebuild from such a crushed level.

The rate of money creation under this system was high, typically seven to ten percent per year, according to BOJ statistics available from the US Federal Reserve. (footnote) However, this rate of money production resulted in only moderate consumer price increases because Japan grew

its production so fast. For the most part, the production of industrial and consumer goods kept up with the production of money.

However, when the US abandoned the gold standard in 1971, the dollar fell hard against the yen and other currencies, making Japan's exports less competitive in price. To protect its export markets, the BOJ needed to weaken the yen, so through directed lending it expanded money rapidly in the early 1970s, sometimes at annual rates of over 25%.

[slide – Nikkei 225]

The resulting devaluation and inflation caused a jump in the stock market. **In the 18 months from August 1971 when Nixon announced the abandonment of gold, Japan's stock market more than doubled. I place this period, the early 1970s, as the birth of the bubble that eventually blew up in the following decade.**

In the 1980s, the world's central banks, led by the U.S., were calling for reform. The US position was that the Japanese banking system was subsidizing Japanese export industries to the detriment of US companies. In *Princes*, Werner documents the international pressure, especially from the USA, to abolish the war economy banking system and adopt US-type policies.

These recommended reforms included a more Western-style, independent central bank structure. The BOJ agreed with this position and was eager to assert its independence from the Ministry of Finance. But the tradition-minded MOF disagreed, making change very difficult politically. According to Werner, **the BOJ leaders concluded that real change could come only in the wake of a financial crisis. So the BOJ set about to engineer a financial crisis**, believing that was the only way to convince citizens and interest groups of the need for structural change in the government and the economy.

Werner's interpretation of the BOJ's motive is provocative, but what is not controversial is that in the 1980s, the BOJ started aggressively increasing window guidance toward the real estate sector. Average annual growth in loan quotas grew to 15% by the late 1980s, exceeding what even the bankers asked for. The result was a big boom in real estate and stock market prices.

You can see the results in the parabolic rise of stock prices from 1984 to late 1990. Prices of real estate were even more extreme. Quoting from Werner:

[slide-Werner quote]

> "Between 1985 and 1989, stock prices rose by 240%. Land prices increased 245%. By the end of the 80s, the garden around the imperial palace in Tokyo was valued equally to the entire state of California. The market value of only one of Tokyo's 23 districts, the central Chiyoda Ward, exceeded the value of the whole of Canada. Although Japan has

> less than 4% of the land area of the USA, its land was valued at four times that of the US."

By the late 1980s, speculative fervor took over. Traditional manufacturers started playing the markets – these were company hedge funds (the "Zai Tech") using borrowed money to make speculative investments. Sometimes their investments exceeded the profits from their regular business, as in the case of Nissan the car maker.

Shiny new buildings rose in the cities. The labor market boomed so much there was worry about a serious labor shortage. Companies used expensive holidays to entice new workers. Corporate life became a continual holiday, according to interviews.

Articles on the "new Japanese economy" identified the cause of the apparent prosperity as high and rising productivity. Books on Japanese management emphasizing ancient Samurai war strategies were best sellers. **As often happens, market observers were confusing brains with a bull market.**

Still, the BOJ increased window guidance to property every year. The only way to fulfill these expanded lending quotas was to increase unproductive lending. BOJ offered bankers more than they wanted to lend against property and stocks, and eventually forced the banks to increase their loans. According to an interview with one banker, "A side effect of increased window guidance loan increases was that the banks increased lending even when there was no loan demand." The BOJ was force-feeding its banks like a farmer feeds a barnyard goose.

[Slide – Werner]
Quoting again from Werner:

> "Like all bubbles, the Japanese bubble was simply fueled by the rapid creation of new money in the banking system….When [Toshiko Fukui, head of the Banking Department at the Bank of Japan] was asked by a journalist, "Borrowing is expanding fast, don't you have any intention of closing the tap on bank loans?" he replied "Because the consistent policy of monetary easing continues, quantity control of bank loans would imply a self-contradiction. Therefore, we do not intend to implement quantitative tightening."
>
> - [from the video]

From 1987 onwards, it was not borrowers seeking loans, but bankers pursuing potential customers. Anecdotes abound. Young people in their 20s on modest salaries were given loans for second and third homes. Bankers pursued clients like street peddlers. Interviewee: "If a newlywed couple wanted to buy a house, banks would offer double the amount they asked for." To push the loans, bankers made increasingly exaggerated assessments of land value, which made the loan-to-value ratios look better.

The average Japanese citizen had an idea something was wrong. People in the street called it "excess money."

[slide-Werner]
Werner:

> "Only economists, analysts, and those working in the financial markets or for real estate firms knew better. They dismissed such simplistic analysis. Land prices were going up for far more complicated reasons than just excess money, they claimed. Ordinary people simply did not understand the intricacies of advanced financial technology."

- From the *Princes* video

The bubble eventually spilled over into international investments as wealthy Japanese took their money abroad. Japanese collectors dominated the art world in the 1980s. Japanese tycoons made high-profile purchases, like The Rockefeller Center, Columbia Pictures, and Pebble Beach Golf Course. Hawaii real estate soared due to Japanese demand. In 1986, Japanese money bought a staggering 75% of all new US treasury bonds sold at auction.

***[optional**: Despite its overvalued economy, Japan was able to invest overseas because the currency market (currency traders) did not devalue its currency. **According to Werner, they didn't devalue because they did not see or understand the excess money creation**. The same thing happened in the USA the 1950s and 60s when US banks created excess dollars. US corporations used this plentiful, overvalued ("hot") money to buy up European corporations. The US dollar had the cover of a gold standard. Japan's cover was a trade surplus (at favorable exchange rates).]*

Importantly, it was not only the absolute level of money growth that caused the bubble, **but the direction of spending of the new money** that was supplied first to the real estate sector and then to stock investors, but *not* toward firms that invested in the production of consumer goods. We need to remember the three-hundred-year-old wisdom of Richard Cantillon: prices rose on the items on which the new money was spent, and re-spent.

***[optional**: As Werner explains, these were non-GDP loans. A "on-GDP" based loan is a loan not used for the production of goods and services, but instead on assets like real estate and stocks.*

> *"An early warning indicator of the buildup of systemic risk in the banking system is the ratio of loans for non-GDP based transactions to total loans. This ratio increases significantly in most countries that are subsequently struck by a banking crisis."]*

A similar thing had happened in the USA during the early 2000s housing boom. **The process consists of lending (directing new money) to an asset class that is rising in price because of previous injections of new money. It** was the same process that fueled the mortgage lending and house price booms in the United States and the United Kingdom in the 1980s and again in the 2000s.

The same process had also created the stock market boom in the 1920s. In the 1920s, United States banks loaned against stocks as collateral. Stock investors buy stocks, so that is what they did with their new money. The principle remains the same. As each bank took the stock price as a valid collateral value, it created new money to buy more stocks. With more money entering the stock market, the owners of stocks kept buying stocks, so stock prices had to rise. Lather, rinse, repeat.

It's been said that easy money is a virus that turns investors' brains to mush. As in most financial bubbles, in the latter stages, widespread misunderstanding contributed to the continued expansion of money. Each bank thought it was safe to accept a certain percentage of the value of the stock as collateral, but it was the actions of all banks together that drove up the overall market."

[optional**: The bankers, failing to see this, committed the fallacy of composition. The fallacy of composition is a thinking error that arises when one assumes that something is true of the whole from the fact that it is true of some part of the whole. A simple example might be: "This tire is made of rubber; therefore, the vehicle of which it is a part is also made of rubber." Another example is asking, "How much does the earth weigh?" The question assumes that because it is possible to weigh items on the earth, it is also possible to weigh the entire earth. But obviously, there can be no "weighing of the earth," there is only the weighing of objects on the earth. In the case of the Japanese lenders, **they made the mistake of thinking the rise in market price of an individual bank represented an increase in its market value, not understanding that the rise in the asset's market value was itself due to the bank's lending policies.]

So the Japan asset bubble continued inflating right through the late 1980s. Viewed over the long term, the inflation in the value of Japanese real estate was staggering. According to Werner, "In Japan, **total private sector land values rose from 14.2 trillion yen in 1969 to 2000 Trillion yen in 1989**. This is an increase in prices of 140 times in 20 years, which equates to a rate of increase of about 28% per year."

[slide - Mieno]

Then suddenly, in late 1989, the party stopped. **At his press conference as the 26th governor of the Bank of Japan, Yasushi Mieno said that "Since the present policy of monetary easing had caused the land price rise problems, real estate lending would now be restricted."**

Werner:

> He looked around, looked at the bubble, asset prices rising, the gap between rich and poor getting bigger. Let's stop it. His name was Mr. Mieno and he was a hero in the press because he fought against this silly monetary policy. But the fact was, he was deputy governor during the bubble era, and *he was in charge of creating the bubble*. [emphasis added]

Almost overnight, land and other asset prices stopped rising**. In 1990 alone, the stock market dropped by 32%**. Then in July 1991, window guidance was abolished. Bankers were now left almost helpless because they did not know how to make their lending plans anymore. Without window guidance, they had no idea how much to lend, or to whom. As banks began to realize that the majority of the JPY 99 tTrillion in bubble loans was likely to turn sour, they became so fearful that they not only stopped lending to speculators but also restricted loans to anyone else, even those deserving of credit.

Without new money to feed its rise, the stock market continued to collapse and with it many of Japan's leveraged companies. Many listed companies went under. Between 1990 and 2003, 212,000 companies went bankrupt. In the same period, the stock market dropped by 80%. Land prices in major cities fell by up to 84%. Five million Japanese lost their jobs and did not find employment for years. Suicide became the leading cause of death for men between the ages of 20 and 44. According to anecdotal reports, people were hanging themselves and going missing on a daily basis.

But BOJ Governor Mieno found a silver lining in the growing recession, saying it made the population conscious of the need to implement economic transformation, by which he meant central bank independence. By Werner's account, Mieno had created the bubble, and Mieno popped the bubble.

In the years following the bust, several recovery remedies were tried. **MOF pressured BOJ to lower interest rates to spur lending, but that didn't work despite the lowering of interest rates to near zero.**

Next the MOF tried to devalue the yen vs. the dollar, to stimulate exports. But the BOJ sold assets to raise yen to buy dollars, which decreased the money in the economy, which was deflationary in an already deflating economy. So the yen did not weaken.

Then the MOF tried fiscal stimulus which was supposed to increase loan demand. But they were funding government spending through taxation. With no increase in the money supply, the asset price implosion continued.

By Werner's account, the BOJ refused to engage in the necessary money creation that would alleviate the crisis, deliberately prolonging the recovery just to get the structural changes they wanted.

Finally, in 1998, the Princes of The Yen at the BOJ got their wish and became independent of the MOF. But this had come at great cost to the Japanese people.

[slide – asset inflation]

Werner sums up the bubble, echoing my previous comments on speculative bank lending:

"Asset inflation can go on for several years without major observable problems. However, as soon as the credit creation for non-GDP transactions stops or even slows, it is 'game over' for the asset bubble: asset prices will not rise any further. The first speculators, requiring rising asset prices, go bankrupt, and banks are left with non-performing loans. As a result, they will tend to reduce lending against such asset collateral further, resulting in further drops in asset prices, which in turn create more bankruptcies."

- [quote from the video]

*[**optional:** When asset-based lending had become a major part of bank portfolios and when banks had already driven up asset prices by several hundred percent due to their excessive asset-based credit creation, then it is inevitable what will follow: bank equity is usually less than 10%, and thus asset prices need to fall only by a little more than that – which is not difficult, after rises of several hundred percent – and the banking system is bankrupt: losses from non-performing loans have to be made up from equity (if no other funds are available, which is usually the case in such situations).*

"Thus a full-blown banking crisis must follow after a bank-credit driven asset bubble. One does not need to be a central banker to know this very well. (Why, then, did the ECB allow 20% or more bank credit growth in Ireland, Portugal, Spain and Greece, for several years? Such high credit growth is clearly in excess of nominal GDP growth and hence it is clear that it must be creating unsustainable asset bubbles that result in banking crises – as the Quantity Theory of Credit has postulated since its inception in 1992; Werner, 1992, 1997; 2012, 2013).]

What conclusion can we draw from the famous Japan asset bubble? As Werner puts it, central banks hold obscure, independent powers that are not always well understood. But we do know their main weapon is the power to cause the banks to create new money and distribute that money to specific recipients who spend the new money in specific markets.

In 1980s Japan, new money was knowingly directed by a central monetary authority into property markets. **This caused a large and rapid increase in property prices that spilled over into the stock market, international investment, speculation, and gambling**. The consequences of misdirected credit were many years of distorted price signals, malinvestment, and wasted capital. When credit creation was withdrawn, the bubble burst, followed by years of deflation, stagnation, and severe economic and social hardship, not to mention widespread poverty and suicide.

In such situations, in my view, the best option is to let markets repair the economic damage through free market price discovery and creative destruction. But once a credit bubble has been created, there are no painless options.

EXAMPLE TWO: THE "EVERYTHING BUBBLE": 13 YEARS OF QE, TOPPED OFF BY PANDEMIC QE

[slide]

"The whole point of QE, at least initially in 2009, was to make sure that the contraction in bank credit that was destroying money was offset by a central bank creating money. The Fed created money by buying assets from financial institutions, primarily Treasury securities, and with little delay those financial institutions used their growing liquid funds to buy assets. The downward spiral in asset prices was prevented, and, with a lag, bank credit stabilized and slowly began to grow again as the US private sector began to increase their borrowing."

- Russell Napier, *Solid Ground* (subscription only) 4 Sep 2023

For our next example of bad money creation, let's explore the period of Quantitative Easing (QE), which started in 2009 in the aftermath of the great housing bubble and continued until mid-2022. This period saw the rapid price rise of practically every asset class, including land, houses, commercial real estate, bonds, real estate, and fine art. Some have called it the "everything bubble." I call it the "QE bubble" to identify its cause. Sometimes I also refer to an additional, final surge of QE during the pandemic as "Pandemic QE," but this was really all part of the same grand policy.

The QE bubble is unique in history (to my knowledge) in that it was executed by a coordinated effort of all the major central banks. This massive asset purchase program was conceived and led by Ben Bernanke, Chairman of the Federal Reserve from 2006 to 2014, and continued by his successors, Janet Yellen and Jerome Powell. The QE bubble provides a great learning opportunity because it is recent, very visible, and far-reaching. This is bad money creation at its worst – as bad as it can get without causing a total collapse of confidence in the currency.

I mark the conception of the QE bubble as November 2002, right after the bursting of the tech stock bubble and the ensuing recession. In a speech to the National Economics Club entitled "Deflation: making sure it doesn't happen here," Ben Bernanke, then head of the Federal Reserve Bank of New York, outlined some creative ways in which the Fed, acting in cooperation with the Treasury, could "stimulate" the economy in a crisis. Here is one of several policies he proposed:

[slide]

"Of course, in lieu of tax cuts or increases in transfers, the government could increase spending on current goods and services or even acquire existing real or financial assets. **If the Treasury issued debt to purchase private assets and the Fed then purchased an equal amount of Treasury debt with newly created money, the whole operation would be the economic equivalent of direct open-market operations in private assets**. (Emphasis added)

Ben Bernanke, speech before the National Economists Club, "Deflation: Making Sure It Doesn't Happen Here," November 21, 2002.

https://www.federalreserve.gov/boarddocs/speeches/2002/20021121/default.htm

Read that carefully. His proposal, that the US Treasury should purchase "existing real or financial assets" is equivalent to the government nationalizing private industry, which would be paid for with newly created money.

This is what Latin American dictators are famous for. And it is the pattern the Treasury and Fed would follow twenty years later during the Pandemic phase of quantitative easing, from 2020 to 2022.

That speech was in 2002. Fast forward to 2009 and the post-housing-bubble financial crisis. With the economy not recovering as fast as Bernanke wanted it to, he was ready with a pilot version of the plan outlined in that 2002 speech. The Treasury was not yet ready to purchase private assets – that would come years later during the Pandemic – so Bernanke's plan was to buy assets the Fed was legally authorized to buy, that is, government-guaranteed bonds. He announced a plan to purchase very large amounts (hundreds of billions) of Treasury bonds and government-guaranteed mortgage-backed securities, a policy that soon became known as "quantitative easing."

[optional: As an historical note, "quantitative easing" was a term first used by Richard Werner in his advice to the Bank of Japan in the 1990s.]

As Bernanke explained in a now famous Op-ed to the Washington Post in November 2010, entitled "What the Fed Did And Why":

> "… Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. **Lower corporate bond rates** will encourage investment. And **higher stock prices** will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."
>
> - "Aiding the Economy: What the Fed did and why," Ben S Bernanke, WAPO Nov 10, 2010 https://www.federalreserve.gov/newsevents/other/o_bernanke20101105a.htm

From the text, its clear Bernanke understood he was benefiting the owners of financial assets. If investors felt wealthier, he thought their confidence, or "wealth effect," would trickle down to the Main Street economy in a so-called "virtuous circle" of economic improvement, a kind of rising tide that would lift all boats. Of course, this never happened. What actually happened was the rising tide lifted Wall Street's yachts but swamped the smaller vessels.

*[**optional:** Let's pause if necessary and review what we learned in Lesson Three about how Quantitative Easing creates new money. I figured it out by putting together several things I already knew about money and banking. It's an interesting story because the Fed has never told*

us how QE works, even though the mechanism becomes obvious when you put together a few known facts. The Bank of England has been much more open about it. People have had to figure it out on their own, and this is how I did it.

First, I knew that ***when a commercial bank buys a bond, the bank creates new money to pay for that bond****. So if a bank buys a Treasury bond, it creates new money that the seller of the bond can spend. That is Money Creation 101, which we covered in Chapter 2.*

Next, I knew that ***when a central bank buys a bond from a commercial bank, the central bank creates new cash reserves to pay the bank for the bond****. But in this transaction, no new broad money that can be spent in the economy is created. This is Money Creation 102, which we covered in Chapter Three.*

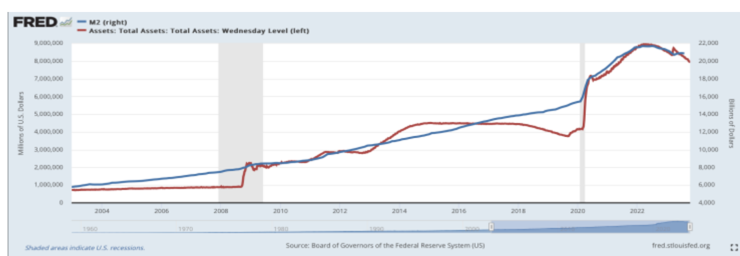
Next, I realized that ***when you do these two transactions at the same time, the end result is 1) new money is created by the commercial bank, 2) new cash reserves replace the bond on the bank's balance sheet, and 3) the Fed gains a new asset (the Treasury bond) and a new liability (cash reserves owed to the commercial bank****).* ***So the net result is that new money and new cash reserves are both created in the commercial banks out of thin air.***

When you do this three-way transaction on a small scale*, creating a modest amount of new money, you put slight upward pressure on bond prices and downward pressure on interest rates.* ***This is called open market operations****, a process the Fed has used for decades to tweak the money supply and interest rates. Let's call this Money Creation 201, the type of thing you would learn in graduate school. This process helps explain creeping inflation, because it is a way for central banks to gradually increase reserves to prop up the banks as they grow their loan books.*

When you do this three-way transaction on a very large scale, and over a prolonged period, the operation is called Quantitative Easing. This is Money Creation 202. Not even graduate schools teach this, as far as I know.]

Bernanke's Op-ed marked the real kick-off to QE, which then lasted for 13 years. Just how much new money was created under this program?

Fed ownership of bonds (red, left) and M2 (blue, right)
2009 - 2023



Here is a graphic showing how much money the Fed caused the commercial banks to create. The blue line read on the right scale shows the broad money supply, M2, which reached a peak of about $22 Trillion in March 2022. The red line, read on the left scale is the Fed's asset purchases, consisting almost entirely of government-guaranteed bonds (Treasurys, agencies, and mortgage-backed securities). The vertical arrow marks the beginning of QE in 2009.

In the 13-year period of 2009 to mid- 2022, M2 increased by $14 Trillion, from about $8 Trillion to $22 Trillion. During the same period, Fed assets increased by $7 Trillion. Every dollar of this $7 Trillion increase resulted in an equivalent increase in M2 in the form of bank deposits. **So, the Fed's QE program produced half of the $14 Trillion in new money (M2) created in this period.**

Because QE pumped most of this new money into the investment markets (including the market for mortgage-backed bonds) asset prices rose just as Richard Cantillon would have predicted: stocks, bonds, house prices, and commercial real estate all went way up. As one example of the inflationary effect of this new money, **here is the Fed's balance sheet compared to the S&P 500 index, which rose over 400% during the QE years**:

Note the near vertical addition of "pandemic QE" starting in March 2020.

Once the Fed got QE underway, all the major central banks around the world joined in with almost identical policies. (Some, like the Chinese, Japanese, and Swiss central banks, even purchased equities. (For details, see my December 2015 essay in *The Objective Standard* – "Central Banks Cross the Fascist Frontier.").

At first, the consequences of this new money flowing into the investment markets were small and unnoticeable to most. But Wall Street soon caught o. By 2012, many hedge fund managers understood the game but didn't say much publicly. One manager, David Tepper of the Appaloosa Fund, finally broke the silence at an investment conference in May of 2015. As reported by *Barrons*, Tepper commented that "four major central banks (central banks of the US, the EU, China and Japan) are pumping liquidity into the system" and "will create another tailwind for equities, even after six years of central-bank fueled growth in stock markets,"

Tepper said, “It’s kind of hard to fight money . . . Don’t fight the Fed. Now you’ve got four Feds. Don’t fight four Feds.”[14]

David Tepper’s *personal* income in 2013 was $3.5 Billion. This windfall was not unique to him. The entire investor class hit the jackpot, as these kinds of gains were repeated year after year.

As in the Japan bubble, **the problem was not just the absolute increase in the quantity of money, but the directing of the new money to specific groups who bought specific assets that benefited them.** During the first 10 years of QE we had absolute M2 increase of about 7-8% annually – higher than normal for a healthy economy that typically grows at a 2-3% real rate, but not high enough to cause runaway consumer prices, which rose only moderately during this time.

Like many others, I expected higher CPI during the first few years of QE, but I was wrong because I had not listened sufficiently to Richard Cantillon. At first, I didn’t understand that the new money was being spent almost entirely on investments and could not quickly spill out into consumer prices.

During most of this period, we had fairly low annual consumer price increases (as measured by the CPI) of 2% and sometimes less. The Fed was more worried about “deflation” than rising asset prices! Nearly all the new QE money was directed to the financial markets, specifically to bonds, stocks, and mortgage-backed securities. This is why interest rates dropped, stock prices soared, mortgage rates dropped to 3%, and house prices soared. David Tepper caught on earlier than I did – kudos to him.

In retrospect, it’s not surprising that new money could stay bottled up in the investment markets almost indefinitely. If you think about it, money can “leak” out of investment accounts to be spent on consumer goods when investments are liquidated to pay the investor, such as when pensions are paid, or when you take a distribution from your 401K plan, or when asset managers spend their fees and bonuses. These payments are a small percentage of the total investment account. So you did see big price increases in yachts and luxury homes, but the leakage was small compared to the quantity of money pumped into asset prices.

There was likely another reason – an economic reason – that consumer prices did not rise more rapidly. This was the effect of inexpensive foreign labor, especially Chinese labor, on the prices of many consumer goods. These low costs were passed on to exported consumer goods, causing prices to be lower than they would otherwise have been – rising at 1-2% instead of, say 3-4%. This is a secondary reason consumer price increases stayed low despite the large increase in the quantity of money during the QE period.

With occasional pauses, QE continued for 13 years, fueling the asset bubble. Every time the Fed tried to scale back on QE or raise short-term interest rates, the stock market faltered, and the Fed responded with renewed bond buying. Fearing a collapse in asset prices, the Fed found

itself in a kind of trap, finding it unacceptable to stop the asset inflation. The word on Wall Street became “buy the dip” because you could be sure the Fed would step in with more money every time the market faltered. The Fed bankers saw little downside to this because, by their understanding, “inflation” was not a problem since consumer prices were still rising at a modest pace.

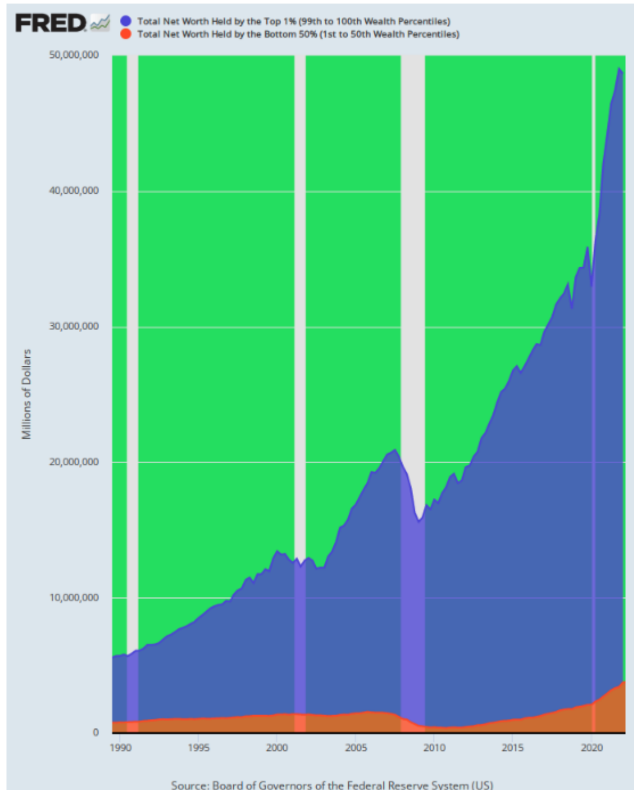
[slide – effects of unproductive money creation]

Ben Bernanke and his proteges Janet Yellen and Jerome Powell continued QE year after year because they thought they were creating a “virtuous circle.” But what were the real economic effects of massive money creation and soaring asset prices? Let’s talk about some of the leading problems associated with this kind of unproductive money creation, things that were going on right under the central bankers’ collective nose.

Effects of unproductive money creation	
	Asset bubbles and suppressed interest rates
	Unjust economic inequality and stagnant wages
	False price signals leading to malinvestment and wasted capital
	Unwanted increases in consumer prices
	Encourages excessive sovereign debt

Unjust Economic Inequality

[slide – Stockman]



https://www.davidstockmanscontracorner.com/trumps-war-on-sound-money-part-1/?mc_cid=ae87679bf3&mc_eid=5ccd0316e7

One of the worst consequences of the QE bubble was the unprecedented extent of unjust economic inequality. I am not speaking here of the normal economic inequality that occurs in a free market due to differing preferences, ambitions, and abilities. I am speaking of the economic injustices that occurred due to the central bank's policy of funneling free money to the investor class. Through its massive bond purchases, the Fed created Trillions of fresh dollars and handed it directly to the players in the investment markets.

This chart, from former budget director David Stockman (derived from Fed data) shows the change in nominal wealth for the one percent of top wealth owners (blue) and for the bottom 50% of wealth owners (red). The parabolic upward slope in the blue line tells you a lot: the top one percent, the David Teppers of the world, received an extraordinary inflationary windfall, while the average citizen was left behind.

These same policies also **suppressed interest rates** by raising the price paid for bonds, because when the price of a bond goes up, the yield on it goes down, pressuring all market interest rates in a downward.

Perhaps the most obvious victims of ultra-low interest rates are the traditional, conservative savers, the bedrock providers of capital in a free economy. To the same extent that early recipients of fiat money prospered from these easy money handouts, savers eventually suffered an equivalent decay of their purchasing power. On Main Street, suppressed interest rates made the honest saver an endangered species. (see my Substack, *"Unmasking Inflation,"*)

***[optional**: Consider an average worker who wants to provide an income of $50,000 for his retirement. Over a lifetime, this worker might be able to save $1 million which, at a typical interest rate of 5%, would provide his annual income. But to generate a $50,000 income when interest rates are near 1%, as they were for years under QE, this worker would have to save $5,000,000, a sum that puts financial security beyond his reach. See my essay "Unmasking Inflation," which illustrates how the Fed's preoccupation with consumer prices hides the real effects of inflation.*

As the famous bond investor Bill Gross commented, "Zero percent interest rates are destructive to the real economy because capitalism can't survive at zero percent. It wasn't meant to be that way."[17]]

So the wealthy reaped a windfall, while the poor and middle class were unable to accumulate wealth. Many pundits blamed this condition on the failures of "capitalism." But true capitalism is a system of justice. The economic inequalities inherent in a capitalist system are appropriate and just because they are consequences of different people's individual choices which encompass vastly different thoughts, goals, choices, and efforts. But this kind of soaring asset prices and near-zero interest rates cannot happen in a truly capitalist system, only in an economy where government causes money to be manufactured wastefully.

Malinvestment

Artificially low interest rates distort normal investment judgment and encourage speculative borrowing, resulting in many non-productive or badly-chosen investments and wasted capital. This is the problem known as "malinvestment," which comes from the fact that price distortions and low interest rates caused by asset inflation make accurate risk assessment impossible, which in turn undermines productive investing.

It's been said both Zombies and Unicorns feast on cheap money. Zombie companies are the walking dead that could not exist without artificially low interest rates. Unicorns are the companies founded on a hope and a prayer that can get money only when it is practically free. Both kinds of companies waste scarce capital, but both are very hard to identify and kill off in a world distorted by ultra-low interest rates.

The Fed's suppression of rates also undermines credit analysis, making it difficult for lenders to distinguish between deadbeats and creditworthy borrowers. And this, in turn, leads to further market distortions—which, in turn, inspire the Fed to attempt further corrections—and so on. James Grant, editor of *Grant's Interest Rate Observer*, puts it this way:

> "Interest rates . . . are universal prices: They discount future cash flows, calibrate risks, and define investment hurdle rates. So, interest rates are the traffic signals of a market-based economy. Ordinarily, some are amber, some are red, and some are green. But since 2008 they have mainly been green."

To put it in personal terms: You may own your home and your car, and you may have a 401k or an investment portfolio consisting of stocks and bonds, but the market value of every one of those assets, as well as the purchasing power of the cash in your bank account, is being manipulated in some way by the central banks when they manipulate money creation and interest rates. You are still free to sell your assets and purchase others, but, whether you know it or not, your decision-making processes are being heavily influenced by the garbled price signals from a rigged market. It's a kind of economic central planning hiding in plain sight.

Stagnant Wages

Unproductive money creation is also a cause of stagnant real wages. Contrary to the claims of central bankers, there is no consistent data proving suppressing interest rates increases growth or employment. Business owners always have limited funds, and when they make investment decisions, they must choose between investing those funds in labor (more employees or higher wages) or capital (machines, buildings, etc.). An artificially low interest rate biases investment toward capital rather than labor, because financing capital projects (like machinery and technology that lead to automation) with borrowed money becomes comparatively cheap. So, in fact, artificially suppressed interest rates may result in lower wages and higher unemployment than would exist in an unhampered market.

This is not to say that labor and capital are naturally antagonists. In a free market, they exist in harmony because unhindered wages and interest rates will constantly adjust to real economic demand. Labor and capital compete for investment to the extent one can substitute for the other. But in an atmosphere of interest rates pushed artificially downward, investment in capital gets an abnormal advantage.[18]

Now consider the sum of these effects on the poor or the middle class which we will call the working class. Their real wages and salaries are suppressed, which reduces their ability to save. They cannot save money in a conservative way because interest rates are so low. What little they can save is gradually eroded by consumer price increases, even if they are modest.

Rising asset prices do not benefit workers who do not own assets. Even when consumer prices are rising slowly, the falling value of money harms everyone, but mostly the working class, whose only real asset is money from a paycheck, with no inflating assets to compensate. Real

production in the economy tends to stagnate due to malinvestment, so the working class suffers more from stagnant living standards. Wage earners see windfalls going to Wall Street for no good apparent reason, and their world appears increasingly unfair because they lose the connection between hard work and success. To get ahead financially, they are virtually forced to speculate in investments where they have no expertise.

Beyond these visible effects, other unseen consequences of bad money creation are the lost opportunities for productive investment that never materialized. What life-serving investments were *not* made because fiat money directed scarce labor and materials to government cronies or wasteful social schemes? What careers were *not* launched, what innovations were *not* developed, because the free market was prevented from steering investment to the right place? We will never know.

[slide - CPI]

THE 'INFLATION" NO ONE SAW COMING

Let's now focus on "Pandemic QE," the acceleration of QE in 2020, which kicked off the consumer price inflation that "no one saw coming" – not the Treasury, not the Fed, not most private economists, who for months insisted CPI inflation was "transitory."   It's true that during the first decade of QE, consumer prices as measured by the CPI advanced modestly, at only about 2% per year. So why did the CPI jump suddenly in 2021? The answer is that during the Pandemic QE period, a large amount of the new money was directed to spending on consumer goods, the same goods that are measured in the consumer price index.

The Fed and the Treasury accomplished this through another radical expansion of the money supply. A variety of Pandeemic "stimulus" programs, passed by Congress and immediately signed by both Presidents Trump and Biden, authorized various ways to get new money into the hands of investors, small businesses and consumers. From 2020 to 2022, about $5 Trillion of stimulus money was paid out to consumers and businesses, most of it borrowed by the Treasury and immediately monetized by the Fed.

Some of the stimulus was in the form of checks sent directly to consumers known as "helicopter money." Some payments were in the form of guaranteed or "forgivable" loans, from special purpose companies set up by the Treasury, directed to individuals and businesses. Some of the programs bought bonds from private companies like Apple and AT&T, just as Bernanke had suggested twenty years earlier. In all, about $5 Trillion in payments went out, paid for with new money: from early 2020 to mid-2022, the money supply went from about $16 Trillion to nearly $22 Trillion, an increase of almost $6 Trillion, most of it created due to the stimulus program.

Richard Cantillon would have known the CPI would blow up, but the Fed and most other economists didn't see it coming till it was right on top of them.

2021-22 PANDEMIC QE AND CPI INFLATION

***[optional**: In the early weeks of 2020, most economic indicators (like unemployment, CPI inflation, and GDP growth) were flashing green. But then came the pandemic and the government lockdown. Within weeks, the stock market crashed, commerce virtually stopped, and unemployment soared. A microscopic bug called SARSCV2 (?) was the spark, but the government's ham-fisted response was the flame, that burned down the economy.*

The economic crisis of 2020 originated in Washington, not Wuhan. After years of low interest rates, our pre-virus financial structure highly leveraged. What were its problems? Debt-ridden balance sheets, over-priced assets, and hordes of unprofitable companies kept upright by a near-zero cost of borrowing, to name a few. And where did this unstable structure come from? Principally, as we have seen, it came from the Fed. During the QE years, the Federal Reserve created money to buy government bonds, to push down interest rates to their lowest levels in 4000 (that's four thousand*) years, to raise asset prices, and to make the rich feel richer. This "wealth effect," said the Fed's learned Doctors of Economics, would dribble down from the affluent to the less fortunate, boost consumption, and, finally, arouse a comatose economy.*

That, as we have seen, was a financial fairy tale. Instead of reviving the masses on Main Street, years of QE and low interest rates weakened the financial structure.

But loans come due and must be repaid or refinanced to avoid default. When an economy stops, as it did when the government sent everyone home, lenders demand cash that leveraged borrowers in marginal businesses cannot generate. Weakened by the Fed's policies, companies were ill-equipped to handle the panic selling, the collapse of asset prices, the closing-up of credit, and the scramble for cash that followed the shutdown. The wise men at the Fed and Treasury responded by doing the only thing they know to do: print more money.]

[slide of Fed assets]

Where did the U.S. Treasury get all this new money? Not from tax collections. All of it was borrowed by selling Treasury bonds, and then an equal number of bonds were quickly monetized by the Fed through a massive surge in QE bond purchases.

*[**optional**: In a Bloomberg op-ed, Wall Street economist Jim Bianco explained how they do it:*

> *"To put it bluntly, the Fed isn't allowed to do any of this. The central bank is only allowed to purchase or lend against securities that have a government guarantee. [So] The Fed will finance a special purpose vehicle (SPV) for each acronym to conduct these operations …. In essence, the Treasury, not the Fed, is buying all these securities and backstopping of loans; the Fed is acting as a banker and providing financing… In other words, the federal government is nationalizing large swaths of the financial markets.* ***The Fed is providing the money to do it…"***

It might have been more accurate to say, "The Fed is requiring the commercial banks to provide new bank deposits to the sellers of the Treasury bonds, converting this new debt into new money."

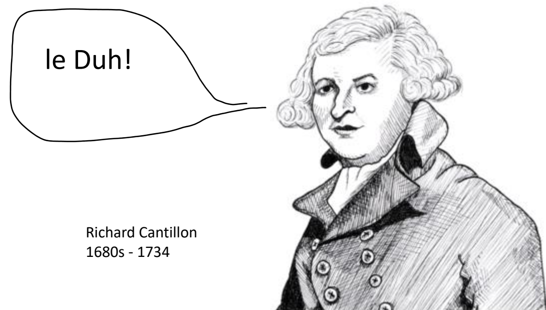
It was clear that simply purchasing more Treasurys and mortgage-backed securities would not get money to individual citizens and small businesses. As we saw, Bernanke had previously suggested a kind of partnership between the Treasury and the Fed to get money directly into the hands of the public. That's why the Treasury got involved with its special purpose lending companies, which were funded by the Fed.]

In a nutshell, Congress approved massive new spending designed to get new money directly into the hands of consumers and corporations. It's a variation on QE and here's how it works: The Treasury borrows Trillions of dollars from investors, providing Treasury the money it needs for its stimulus giveaway program. Recall that sending money to the Treasury (in this case, investors buying Treasury bonds) moves deposits and reserves out of the banks and into the Treasury's General Account (TGA) held at the Fed. To counter the loss of bank deposits, the Fed simultaneously purchases an equivalent amount of bonds from the bond market, creating new money to replace the money that went to the Treasury. The result is the public still holds the same amount of Treasurys and bank deposits as they did before the stimulus. What has changed is the Fed owns a lot more bonds <u>and the Treasury has a lot of new money to spend</u>. As the Treasury sends out Trillions in checks from the TGA, this money is deposited in the bank accounts of consumers and businesses. As the money is deposited, the commercial banks get their reserves back, and consumers (bank deposit owners) have massive amounts of new money to spend on the items that comprise the CPI.

This is how huge amounts of Treasury debt are reorganized into new M2. This is how central banks monetize debt.

The program had a predictable effect. Within a year after the stimulus started hitting the economy, the consumer price indexes jumped and kept on rising, shocking nearly all government economists including Janet Yellen and Jerome Powell. After years of complaining that QE was not creating enough of what they called "inflation" (higher consumer prices) they finally got their wish, in spades.

[slide: Richard Cantillon]



Who'da thunk it? The Treasury and the Fed caused the banks to create massive amounts of new money and handed it to consumers, but because they forgot the Cantillon Effect, they never saw the rise in consumer prices coming.

From 2009 to 2020, new money directed to Wall Street raised the prices of the things Wall Street spends money on: financial assets like stocks, bonds, and real estate. From 2020 to 2022, new money directed to Main Street raised the prices of the things Main Street spends money on: eggs, cars, houses, and most of the other items in the consumer price indexes.

As the Frenchman Cantillon might have said: "le Duh."

Summary Comments:

Japan's asset bubble and the QE asset bubble had much in common. In both cases, excessive money was created in the banks at the direction of the central monetary authority. In both cases, the new money was directed toward buying assets, resulting in higher asset values. In both cases, higher asset prices raised collateral values, justifying increased leverage and more money creation, resulting in even higher asset prices.

In both cases, monetary authorities were confident about their actions because they were not concerned with moderate consumer price increases, which they mistook for "no inflation." In both cases, the process went on for years, spawning a speculative fervor that sucked in otherwise innocent people, eventually ending in tears.

Let's close today's lesson with a couple of summary points.

1. A correct definition of inflation helps us to identify *all* the adverse effects of unproductive money creation, not just unwanted price increases. These effects include unjust wealth distribution, malinvestment, stagnant growth and wages, runaway sovereign debt, and eventual corrosion of public morality.
2. Government monetary authorities cause inflation, and all its adverse effects, by seizing control of the money creation decisions in the commercial banks, directing the new

> money to groups who benefit unjustly. In 1980s Japan, they did it by commanding the commercial banks to lend wantonly to the property sector. In the USA, from 2009 to 2022, they did it by commanding the commercial banks to participate in massive purchases of government bonds, a program called "Quantitative Easing," directing new money first to the Wall Street investor class and ultimately to Main Street consumers and businesses.

Next lesson (Session Six) we will examine what has become the most urgent consequence of excessive money creation: the large, growing, and unpayable debt of most governments, exemplified by "Uncle Sam's Unpayable Debt."

Finally, I'll let the great Henry Hazlitt have the last word on inflation:

[slide]

> "[Inflation] discourages all prudence and thrift. It encourages squandering, gambling, and reckless waste of all kinds. It often makes it more profitable to speculate than to produce. It tears apart the whole fabric of stable economic relationships. Its inexcusable injustices drive men toward desperate remedies. It plants the seeds of fascism and communism. It leads men to demand totalitarian controls. It ends invariably in bitter disillusion and collapse."
>
> - Henry Hazlitt. *Economics in One Lesson*, Chapter 23 (p. 176).

Recommended reading:

- "Unmasking Inflation," https://jim3c5.substack.com/p/unmasking-inflation
- "Central Banks Move Beyond The Fascist Frontier," *TOS*, https://theobjectivestandard.com/2015/12/central-banks-move-beyond-the-fascist-frontier/

END OF MANUSCRIPT