R|W INVESTMENT MANAGEMENT

Wealth Management is an endeavor marked by making important decisions today with imperfect and incomplete information about an uncertain future! As guest author Dr. Peter Crabb writes, this ‘knowledge problem’ also exists for officials at the Federal Reserve (in fact, for all policy makers) as they attempt to set the ‘correct’ interest rate policy for the economy. Please enjoy Dr. Crabb’s thoughts on the knowledge problem and the progress being made by free markets. And please, reach out to us if we can provide you with **Real Wisdom** on your journey to build **Real Wealth** and experience **Real Worth**.

The Fed’s (and Our) Problem

By Dr. Pete Crabb

Do they know what they are doing, or should we end the Fed?

Financial market participants spend much time analyzing and speculating on what the US Federal Reserve will do next. Are interest rates going to continue going up, or is the economy slowing and in need of lower rates?

Federal Reserve Board Chairman Jerome Powell and other members of the committee that set monetary policy frequently speak about the outlook for interest rates and the economy in an effort to maintain transparency for this government agency. It’s hard, however, for any government official to communicate policy in an easy to understand and consistent manner.

Powell said last year that interest rates may need to rise “beyond common measures of neutral and into a more restrictive stance.” He didn’t define either. Chairman Powell testified before Congress last month and said, “Reducing inflation is likely to require a period of below-trend growth and some softening of labor market conditions.” The economy will have to suffer in order for him to do his job.

Last year, former Fed Governor Lael Brainard said that both unemployment and inflation rates were “subject to upside risks.” More recently, Fed Governor Christopher Waller said uncertainty is “which central bankers to some extent always face.” So, nobody really knows.

Investors have always known that the outlook for the economy and the financial markets is unclear. It would otherwise be much easier to plan for retirement and other investing goals. Though well versed in their field, Fed officials are no better at planning for the future. With all the uncertainty, how can these policy makers have any idea as to what should be the appropriate policy response to a dynamic economy like ours?

In answer to this problem, many have called for an elimination of the Federal Reserve or other monetary policy reforms. Idaho State Senator Phil Hart once advocated for an end to the Federal Reserve system and introduced legislation providing for a return to use of precious metals as money in our state. Other states have enacted legislation whereby citizens can pay state fees and taxes with gold or silver.

Arguments for a currency backed by precious metals get good press at times like these when inflation is running higher than normal. Economists have argued that economic and financial volatility is the result of an “unanchored currency.” The government borrows and spends too much because it uses fiat currency. That is, currency that has no underlying, or intrinsic value, like gold.

Economist and former nominee to the Federal Reserve Board, Judy Shelton once criticized the Fed for its manipulation of money and its intervention in the financial markets. Shelton called Fed leaders “communists and socialist planners,” saying we are doomed if we rely on their ability to manage the supply and demand for money.

At the same time, Shelton recommended a panel of "experts" get together and decide how the money supply should be managed. But how would these experts and planners be any different than the current Fed policymakers? What different information do they have? Even if we find a good rule, what stops future government officials from changing it when it is beneficial for them to do so?

The international monetary agreement in place for much of the 20th Century, known as the Bretton Woods system, obligated member countries to maintain the exchange rate of its national currency within a fixed value in terms of gold. When this was no longer beneficial to the United States, as federal spending was rising rapidly to pay for the conflict in Vietnam and new entitlement programs, the government simply abandoned the system. So much for controlling monetary policy or anchoring the currency.

It is not a problem of having the right type of currency or monetary “rules.” No one person or group can know what’s right for money. It is a classic knowledge problem.

In 1945, Nobel prize-winning economist F.A. Hayek published “The Use of Knowledge in Society.” He would go on to win a Nobel Prize for this and related scholarly work.

Hayek identified the specific problem all economic planners face. He wrote that “the ‘data’ from which the economic calculus starts are never for the whole society ‘given’ to a single mind which could work out the implications and can never be so given.” In other words, the Fed will never know the correct interest rate on bank deposits, government bonds, or mortgage loans. The Fed will never know when the economy is at maximum employment, which is what the US Congress has directed them to achieve.

Even if the Fed could collect more information on the economy, setting monetary policy would still be difficult. There are information problems and timing issues that arise with the data these officials consider. Fed members watch the financial markets in an effort to get quality information in a timely fashion. As any investor knows, market prices can move quickly up or down. This is particularly true around the times the Fed is meeting to discuss markets.

Even if the Fed could get the needed information quickly, it takes time to implement any policy response. Fed Governor Waller once pointed out that since the Fed's policy-setting committee is so large (12 in total), reaching a consensus on the appropriate actions is "gradual." Once a decision is reached, the situation has likely changed.

Hayek's answer to this knowledge problem was to let individuals decide what is best for money. His 1976 book titled "The Denationalization of Money" showed how monetary reforms of the past rarely worked, and demonstrated how open and free markets in the production and distribution of currency would bring about innovation and control inflation. In an open market no one would want to hold the currency of a government, or any institution for that matter, which was producing too much of it. As demonstrated in all other markets, efficiency and quality improve when competition arises.

Hayek showed that this is what prices do for all of us. "Fundamentally, in a system in which the knowledge of the relevant facts is dispersed among many people, prices can act to coordinate the separate actions of different people in the same way as subjective values help the individual to coordinate the parts of his plan." Interest rates, or the "price" of money, is no different.

So, we don't need to "end the Fed." We need only expose it to more competition and let the price system work.

Luckily, such a change is underway; and no, it is not coming from cryptocurrencies like Bitcoin. Individuals and businesses can now transact more easily in the currencies of multiple governments. For example, electronic payment processors Paypal and CashApp both provide for transfers in euros or yen, as well as dollars.

As these electronic payment methods gain in popularity, we'll see more people using the "right" money. That is, the better currency. Those governments with poor or uncertain fiscal and monetary practices will see the use of their money decline. As the Old Testament prophet Isaiah said to the leaders of his time, "your silver has become dross," or to say, it is worthless.

Hayek's knowledge problem with money will be solved. The denationalization of money is underway.

Chairman Powell on a neutral interest rate:
https://www.federalreserve.gov/newsevents/speech/powell20220321a.htm

Powell’s June 2023 testimony:
https://www.federalreserve.gov/newsevents/testimony/powell20230621a.htm

Fed Board Member Brainard on uncertainty:
https://www.federalreserve.gov/newsevents/speech/brainard20220405a.htm

Fed Board Member Waller on uncertainty:
https://www.federalreserve.gov/newsevents/speech/waller20230622a.htm

Fed Board Member Waller on lag issues with policy:
https://www.federalreserve.gov/newsevents/speech/waller20220506a.htm

Phil Hart’s proposal for Idaho*:*
https://www.spokesman.com/blogs/boise/2010/mar/24/harts-silver-medallion-bill-killed/

Judy Shelton on the Fed:
https://www.ft.com/content/46c4b186-8308-11e9-b592-5fe435b57a3b

Hayek’s Knowledge Problem:
https://www.econlib.org/library/Essays/hykKnw.html