

# A Modest Proposal for Reining in the “Unorthodox” Fed

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## Abstract

In the years immediately prior to the financial crisis, the doctrine of an independent Fed had achieved broad and unquestioned acceptance, especially within the economics profession. Under cover of this doctrine, the Fed deployed “unorthodox” monetary policies to vastly expand its balance sheet as well as the range of its activities in financial markets. This unilateral and arbitrary expansion of the Fed’s powers, combined with its failure to stimulate a robust recovery from the Great Recession, has provoked increasing opposition even among some economists. In this changing intellectual climate, the time is ripe to implement a short-run program, under the existing regime of the fiat dollar, to terminate the Fed’s anomalous status as a quasi-independent agency and make it directly accountable to Congress like any other department or agency of the executive branch.

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## I. Introduction

“Unorthodox” monetary policies were devised in reaction to the financial crisis by unaccountable and unsupervised Federal Reserve bureaucrats led by then Fed chair Ben Bernanke. These “unorthodox” or “unconventional” policies include the zero interest rate policy, policy duration commitment, quantitative easing, and credit easing.<sup>1</sup> They have been used to drive the (riskless) interest rate to zero and to recklessly expand the monetary base and, to a lesser extent, the money supply. Under the guise of its function as a lender of last resort, the Fed under Bernanke also contrived a host of one-off programs that have usurped the credit allocation function of financial markets (White 2014). The central policies of the

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<sup>1</sup> For a description of these unorthodox monetary policy tools, see Cecchetti and Schoenholtz (2011, pp. 475–80), Erber (2012), Lachmann (2013), and Kuttner (2013).

unorthodox Fed have continued unabated under the chairmanship of Janet Yellen. The grudging acquiescence of both the public and politicians in this unprecedented expansion of Fed powers is attributable to the intellectual dominance that the doctrine of Fed independence achieved during the Greenspan era.

The next section briefly recounts how the idea of an independent central bank came to command such widespread and unquestioned acceptance during the two decades leading up to the financial crisis. Section 3 describes the rapidly intensifying disillusionment with the Fed that emerged during the stagnant recovery from the Great Recession and that now threatens its independence. Section 4 describes and evaluates the feasibility of a proposal for stripping the Fed of its independence within the framework of the current fiat-dollar system.

## **II. The Emergence of the Ideal of Fed Independence**

During the 1980s and 1990s, the desirability of the “independence from politics” of central banks became almost an article of faith among mainstream macroeconomists and those operating in financial markets.<sup>2</sup> This development was driven by two factors: academic research on central banking, and the personality cults that grew up around the two Fed chairmen during this period, Paul Volcker and Alan Greenspan.

Research on central banking became a veritable growth industry during the 1980s and 1990s.<sup>3</sup> A great deal of this research early on was devoted to examining the effects of central bank independence on the inflation rate. The consensus view that emerged from this literature was that central bank independence was strongly correlated with lower inflation rates and no appreciable deterioration in real output performance (see, e.g., Alesina and Summers 1993).

Further research in the 1990s focused on the optimal design of a central bank. This research led to the discovery of a pronounced decline in the level and variability of the inflation rate accompanied by a reduction in the volatility of real output that began in the mid-

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<sup>2</sup> For a recent survey of the debate over the meaning and desirability of an independent Fed, see Robbs (2011).

<sup>3</sup> A computer search conducted by Blinder (2004, p. 3) on EconLit turned up 980 references in the 1970s, which doubled to 1,929 in the 1980s and reached a “staggering” 4,921 in the 1990s.

1980s.<sup>4</sup> Thus was born the myth of the “Great Moderation,” which spanned the roughly two decades from 1985 to 2006. This new era of macroeconomic stability was attributed in large part to the “quiet revolution” in central banking, which involved fundamental changes in the structure and operating procedures of the Fed and other central banks (Blinder 2004). The paradigmatic shift in central banking organization was widely touted as the result of the newly emerging consensus among economists regarding the optimal organizational structure of a central bank. The revolution was instantiated in the three major central banks—the European Central Bank, the Bank of Japan, and the Fed—which were designed or redesigned “from scratch” during the 1990s based on the new research in monetary policy (Blinder 2004, p. 56; Cecchetti and Schoenholtz 2011, p. 384). A salient feature of these newly designed central banks was the enhancement of their formal independence from government and politics. This narrative became a new orthodoxy among economists and quickly became entrenched in textbooks on money and banking and on macroeconomics.

In a famous speech in 2004, Ben Bernanke (2004), then a Fed governor, proclaimed “that improvements in monetary policy, though certainly not the only factor, have probably been an important source of the Great Moderation.” In an article ironically published shortly before the financial crisis struck, Frederic Mishkin (2007, p. 20), a prominent monetary economist and at the time a Fed governor, triumphantly concluded, “The practice of central banking has made tremendous strides in recent years. We are currently in a highly desirable environment that few would have predicted fifteen years ago: not only is inflation low, but its variability and the volatility of output fluctuations are also low. . . . new thinking about monetary policy strategy is one of the key reasons for this success.”<sup>5</sup>

While academic economists were building a theoretical case in favor of an independent central bank, a cult of personality was developing around Volcker (1979–87) and Greenspan (1987–2005),

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<sup>4</sup> Mishkin (2007, pp. 1–27, 489–535) and Blinder (1998, 2004) present detailed surveys of this literature, copious references to which can be found therein. For a good textbook summary of the literature, see Cecchetti and Schoenholtz (2011, pp. 382–89, 407–10).

<sup>5</sup> Although this represents the consensus view, some economists suggested that other factors were more important than improvements in monetary policy in causing the Great Moderation. For an overview of the debate about the causes of the Great Moderation, see Stock and Watson (2003).

whose tenures coincided with the Great Moderation. Both men came to be revered by the financial markets, politicians, and even the public. A fawning media portrayed them as large-than-life characters—“Money Man” and “Maestro”—whose slightest utterance or vocal inflection could move markets. Both Volcker and Greenspan cultivated this image by forsaking plain speech and perfecting idiosyncratic styles of “Fedspeak,” a convoluted and empty rhetoric designed to obfuscate even the simplest issues and give their public pronouncements a murky, oracular quality that hinted at deep wisdom and unerring intuition (Salerno 2001).

In the latter stages of the Great Moderation, the view of Alan Greenspan as a maestro in conducting monetary policy began to pervade even the economics profession. For example, Alan Blinder (2004, p. 6), a Keynesian who had been vice chairman of the Fed under Greenspan in the late 1990s and often crossed swords with him, gushed in 2004 that he would rate “our own Alan Greenspan . . . as the greatest central banker in history.” Even Milton Friedman, a hard-edged and long-time critic of the Fed, fell victim to the Greenspan cult. This is evident in a remarkable televised interview that Friedman gave to Charlie Rose in December 2005. Early in the interview, Friedman (2005) stated, “The United States is at the peak of its performance in its history. There has never been a time in the United States when we have had the state of prosperity, its level and its spread, that we have had in the last ten or fifteen years. There has never been a fifteen-year period in which there has been so little fluctuation in prices, in inflation. I certainly do [give credit to Alan Greenspan for that].

Rose then queried Friedman, “You think that Alan Greenspan . . . was the greatest Federal Reserve Chairman ever?” Friedman responded, “There has been no chairman since [the founding of the Fed] who has anything like as good an outcome. . . . I very seldom had anything good to say about the Fed before the 1980s. But since Alan Greenspan took over I’ve very little but good to say.”

A few years earlier, Friedman had already given up his long-held position that the Fed be bound by some kind of quantity rule legislated by Congress specifying a rate of growth for the money supply or, later on, for the monetary base. The reason for his change of position, according to Friedman (2003), was because “sometime around 1985, the Fed appears to have acquired the thermostat that it had been seeking the whole of its life.” That “thermostat” was the quantity equation, which, Friedman believed, the Fed had learned

how to use in varying the money supply inversely to changes in the velocity of money so as to maintain a low rate of consumer price inflation.

The Greenspan mystique fed into and reinforced the macroeconomic consensus that the ideal monetary arrangement was an independent central bank under the leadership of an intuitive and strong-handed chairman.

### **III. The Financial Crisis and the Backlash against Fed Independence**

In the decade leading up to the financial crisis, the intellectual climate was such that anyone suggesting that the Fed have its independence curtailed or even abrogated by Congress would have been considered beyond the pale of rational, let alone scholarly, discussion. After the bursting of the housing bubble and the onset of the financial crisis, the popular attitude toward the Fed changed suddenly and radically. Hagiographic accounts like *Maestro: Greenspan's Fed and the American Boom* (Woodward 2000) and *Greenspan: The Man Behind Money* (Martin 2000) hailing Greenspan's wizardry as Fed chairman abruptly ceased being published. Books with titles like *Panderer to Power: The Untold Story of How Alan Greenspan Enriched Wall Street and Left a Legacy of Recession* (Sheehan 2010) and *The Global Curse of the Federal Reserve* (Brown 2011) began to pour forth from mainstream publishers. Representative Ron Paul's bill to audit the Fed (Federal Reserve Transparency Act 2009), introduced in the House of Representatives in 2009, received broad grassroots support and garnered 309 cosponsors in the House. It was passed by the House, 327 to 98, in mid-2012 after it was reintroduced in the subsequent Congress.<sup>6</sup>

Most economists, however, stuck to the textbook story they created in the 1990s and early 2000s. They blamed unruly financial markets and the inadequacy of the existing regime of financial regulation to rein the markets in. Their attitude was exemplified by Cecchetti and Schoenholtz (2011, 384) who characterized the financial crisis as just another learning experience for the Fed that would lead to further improvement in its conduct and performance, because the crisis had spurred economists to explore "how to improve financial regulation" and to reconsider "the role that central banks should play in financial supervision." However, as the painful

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<sup>6</sup> A Rasmussen Reports (2013) national telephone survey found that 74 percent of American adults favored auditing the Fed and making the results public while only 10 percent were opposed.

and protracted recovery from the Great Recession has dragged on, even economists and financial pundits have begun to challenge the Fed's independence of "politics"—of legislative oversight and constraint.

Professor Amar Bhidé (2013) argues in favor of "re-decentralizing the Fed," noting, "A more decentralized monetary authority would align better with America's democratic traditions and economic reality." He suggests that Congress relieve the Fed of its "unrealistic" dual mandate and that the Fed be charged only with "forestalling the monetary instability that can trigger intolerable inflation or mass unemployment." In addition, the Fed's interventions should be limited "to those that serve its original purpose of ensuring an adequate monetary base and acting as a lender of last resort." Bhidé further recommends that "major changes in Fed policy—such as the decision to purchase trillions of dollars' worth of securities or push interest rates to zero . . . be subjected to legislative approval (except in times of emergency)." Such an arrangement, contends Bhidé, "would reduce the Fed's independence, [and] would put the onus of difficult political decisions where it belongs: on the democratically elected members of Congress."

Market monetarists Marcus Nunes and Benjamin Mark Cole (2013) suggest that in the absence of external oversight and accountability, a central bank will develop its own internal goals and standards while performing poorly, becoming increasingly insular and elitist, and disregarding the public interest. They also rebut the argument that monetary policy requires technical expertise that is beyond the grasp of the public and their elected officials:

The stance that central banks should be independent hardly withstands comparative scrutiny—for example, in democracies, the voting public selects civilian leadership for military agencies (The President of the United States is also the Commander in Chief). . . . Similarly, in most democratic nations, important fiscal and regulatory agencies . . . are not thought above the reach of ordinary politics and elections. . . . That monetary policy is somehow *sui generis* becomes an even more difficult case to make.

In an article for the American Enterprise Institute, an establishment think tank, James Pethokoukis (2013) asks, "Should the Fed Be Part of the Treasury Department?," giving a sympathetic account of the arguments of Bhidé and of Nunes and Cole.

Prominent monetary economist J. Huston McCulloch (2014) proposes that Congress pass legislation “in order to rein in the Fed.” This legislation would rescind the Fed’s power to pay interest on excess reserves and restrict the Fed’s asset acquisitions to “the traditional categories” such as US Treasury securities and collateralized discount loans to solvent, FDIC-insured commercial banks.

There have also been a number of recent books and articles by financial writers supporting legislation that would mandate the Fed to target the price of gold within a narrow range using conventional open market operations (Forbes 2013; Lewis 2013; Woodhill 2011, 2013).<sup>7</sup> Other writers, such as Lewis Lehrman (2012), have proposed a legislated restoration of the classical gold standard in which the Fed would be barred from conducting open market operations but would still exist and function as a lender of last resort.<sup>8</sup>

#### **IV. A Proposal to Rein in the Fed**

None of the recent proposals to curb the Fed’s independence mentioned so far envisions fundamental institutional reform of how base money is supplied under our current fiat-dollar regime. One such reform would involve wresting control of the money supply from the unelected bureaucrats at the Fed and returning it to Congress and the Treasury. In fact, this idea was put forward during the controversy over raising the debt ceiling, shortly after the idea of the Treasury issuing the trillion-dollar coin made headlines in early January 2013. Several commentators observed that the coin scheme had implications far beyond a one-off political maneuver to avoid the debt ceiling and that it presented a radical if implicit challenge to the Fed’s independence. Michael Sandler (2013), a left-wing populist blogger, recognized that the coin gimmick provided an entrée to promote a monetary reform program based on the template developed by the populist, anti-Fed American Monetary Institute (AMI) (2009). Sandler (2013) welcomed the minting of the trillion-dollar coin as a step toward implementing a central element of this

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<sup>7</sup> This proposal is the basis of a congressional bill, HR 1576 (the Dollar Bill Act of 2013), which was introduced into the US House of Representatives on April 16, 2013, by US Representative Ted Poe (R-Texas). For a detailed description and critique of the bill and the arguments of its proponents, see Salerno (2014).

<sup>8</sup> For comments on the potential drawbacks of Lehrman’s proposal, see Salerno (2014, pp. 86–87).

program. “Repeal the congressional mandate for the Treasury to issue debt when it deficit spends,” he said. “Instead, the Treasury could be allowed to spend money into circulation directly, or use debt-free instruments . . . in its money creation process (with or without the Federal Reserve).”

There are three main elements of the AMI monetary reform program, only two of which concern us because they are directly related to money. “First, incorporate the Federal Reserve System into the U.S. Treasury where all new money would be created by government as money, not interest-bearing debt; and be spent into circulation. . . . Second, halt the bank’s privilege to create money by ending the fractional reserve system. . . . All the past monetized private credit would be converted into U.S. government money. Banks would then act as intermediaries accepting savings deposits and loaning them out to borrowers” (AMI 2009).

It is important to note that this blueprint for monetary reform closely approximates—in its fundamentals if not in its aim or sophistication—the monetary and fiscal framework that Milton Friedman (1970) proposed in 1948. The monetary component of the proposal focused on eliminating “both the private creation or destruction of money and the discretionary control of the quantity of money by central-bank authority” (Friedman 1970, p. 135). The first goal would be attained by implementing Henry Simon’s Chicago Plan for 100 percent reserve banking. Friedman (1970, p. 139) maintained that the second objective could be achieved by eliminating the issuance of interest-bearing government securities to the public, thereby restricting the financing of government spending to taxation and money creation (i.e., the issuance of “non-interest bearing debt”). Thus, as Friedman (1970, p. 140) pointed out, “Deficits or surpluses in the government budget would be reflected dollar for dollar in changes in the quantity of money; and, conversely, the quantity of money would change only as a result of deficits or surpluses.”

A common objection to such a proposal is that if money were under the control of the Treasury, monetary policy would become a political football and inflation would run rampant. But how much more inflationary would monetary policy become than it is right now? The unelected and unaccountable bureaucrats at the Fed have fastened on the US economy a regime of zero interest rates, quantitative easing, and the targeting of a real variable (the unemployment rate) using nominal variables. The latter is a reversion

to stone-age Keynesianism. Indeed, current Fed policy has enabled a fiscal policy of high deficits and rapidly mounting national debt.

Let us grant for the sake of argument that congressional control of monetary policy alters the mix of financing government spending toward less taxation and more deficits financed by money creation. From the point of view of Austrian public finance theory, the *method* of governmental “revenue extraction” does not matter nearly as much as the *total amount* extracted. All government spending drains resources from productive uses in the private economy and squanders them through the wasteful spending of politicians and bureaucrats on their favored projects and constituencies. Government spending is either consumption spending that directly satisfies the preferences of members of the political establishment or it is investment in waste assets because it is not based on the profit and capital-value calculations that guide the decisions of private entrepreneurs and capitalists. It is, in effect, a redistribution of income and resources from the productive to the unproductive, from the taxpayers to the tax consumers.<sup>9</sup>

The total amount of government spending is therefore what Murray Rothbard (2008, p. 339) called “government depredation on the private product.” For Austrian economists, then, the method of financing government depredation—whether it be taxation, borrowing from the public, or money creation—is of secondary importance. Thus, *at a given level of government spending*, siphoning off resources from the private economy via deficits financed by money creation is no worse than extracting them through taxation. Indeed, inflationary finance may even be preferable to taxation because the threat of physical coercion implicit in taxation has a detrimental effect on the direct utility of private individuals that goes beyond the expropriation of their income. As Rothbard (2006, pp. 10–11) stated,

It is true that inflation is a form of taxation, in which the government and other early receivers of the new money are able to expropriate the members of the public whose income rises later in the process of inflation. But at least with inflation people are still reaping some of the benefits of exchange. If bread rises to \$10 a loaf, this is unfortunate but at least you can still eat the bread. But if taxes go up, your

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<sup>9</sup> For an elaboration of this Austrian approach to taxation, see Rothbard (2009, pp. 1149–55).

money is expropriated for the benefit of politicians and bureaucrats, and you are left with no service or benefit.

Needless to say, from the viewpoint of consumer welfare and economic efficiency, a smaller government budget financed by money creation is preferable to a larger budget that is in balance. For example, if confronted with a choice between an annual US government budget of \$2 trillion financed wholly by money creation and a balanced budget of \$4 trillion, most Austrians and many other free-market economists would consider the former to be less disruptive of the market process and less injurious to the welfare of individuals who earn their income through voluntary market activities. It is thus the total level of *depredation* on private producers and consumers, as reflected in government spending—assuming that it is higher than tax revenues—that matters most for Austrian welfare analysis; *deficits* and *debt* are, at best, of secondary importance and obsessing about them diverts attention from the true fiscal burden of government.

Legislative control of the fiat money supply is far from the ideal monetary system. The desideratum of the Austrian political economist with classical liberal or libertarian leanings involves the complete separation of government and money through the establishment of a commodity money like gold (or silver), the supply of which is determined exclusively by market forces. Nonetheless, there is great merit in replacing the opaque and pseudoscientific control of “the money supply process” by the Fed’s entrenched bureaucrats with overtly political control of money by elected officials and partisan administration appointees. Stripping the Fed of its quasi-independent status and transforming it into a handmaiden of the Treasury, as the AMI and early Friedmanite reform programs call for, would have several benefits.

First, money would be created in a transparent manner that the public at large can understand. The Treasury would simply send an administrative order to the Fed to credit its checking account with the sum of money needed to pay the government’s bills that are not covered by tax revenues. Formally, this order may be called a “Treasury bond,” but it would not be a bond in the economic sense because it would not be exchanged in financial markets, nor would the “interest” that the Treasury may pay on these pseudo-bonds really be interest because it would not be determined by supply and demand in financial markets. Rather, it would be a payment to reimburse the administrative costs of the Fed and its amount would

be completely controlled by the Treasury. It thus becomes evident to the public that every increase in the money supply engineered by the Treasury benefits the *specific* individuals and firms receiving government checks. The new money is being created from nothing to purchase military aircraft from Boeing, to subsidize agribusiness giant Monsanto, to bail out General Motors, and so on.

This contrasts with the arcane process by which money is now created, which involves the Treasury issuing debt that is purchased by private entities, mainly banks and other financial institutions, and then eventually repurchased by the Fed via open market operations. In this way, the Fed circuitously “monetizes the debt” and expands the money supply while distorting interest rates in the process. Invisible to the layperson is the fact that twenty or so privileged Wall Street (and foreign) banks and financial institutions—so-called “primary dealers”—that sell bonds to the Fed profit immensely from the money-creation process. Also benefiting from the newly created reserves are the commercial banks’ business clients who borrow the money at reduced interest rates and spend it to appropriate extra resources before prices have begun to rise.

Giving the Treasury control over the money supply by enabling it to draw checks on deposit balances that it “borrows” from the Fed yields another benefit. It not only shuts the Fed out of financial markets and renders the money creation process transparent; it also completely cuts out the banks from a key role in the money-creation process. As Friedman (1970, pp. 135–36) pointed out, the 100 percent reserve provision “separate[s] the depository from the lending function,” leaving the banks to function merely as money warehouses. From the perspective of Austrian business cycle theory, the suppression of the issue of fiduciary media would eliminate cycles of boom and bust, although inflation would certainly still be a grave danger.<sup>10</sup>

This is a strong claim that merits further analysis. When new money is injected into the economy via open market operations, as it is today, it expands bank reserves. The lending out of these created

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<sup>10</sup> Friedman (1970, p. 156) recognized this danger of his proposal but argued, “It can probably be avoided only by moving toward . . . an entirely metallic currency, elimination of any governmental control of the quantity of money, and re-enthronement of the principle of a balanced actual budget. Friedman (1970, p. 155), who rejected the Austrian theory of the business cycle, did not claim that his monetary framework “would eliminate entirely cyclical fluctuations of income and output.”

reserves by fractional-reserve banks artificially reduces the interest rate below the natural level determined by the voluntary saving of private income-earners. The distorted interest rate falsifies the profit and wealth calculations of entrepreneurs and households causing malinvestment and overconsumption and precipitating the boom-bust cycle that potentially culminates in asset bubbles and a financial crisis (Salerno 2012). In contrast, when the Treasury creates money, it does so by writing checks for bureaucrats' salaries, for entitlement payments, and to pay vendors for government purchases. This mode of money creation causes what Ludwig von Mises called "simple inflation," which does not generally perturb financial markets and systematically distort interest rates. As Mises (1998, p. 570) explained, financing Treasury borrowing directly from the central bank is no different from a government simply creating fiat money to finance its spending:

The treasury borrows from the bank, and the bank provides the funds needed by issuing additional banknotes or crediting the government on a deposit account. Legally the bank becomes the treasury's creditor. In fact the whole transaction amounts to fiat money inflation. The additional fiduciary media enter the market by way of the treasury as payment for various items of government expenditure. It is this additional government demand that incites business to expand its activities.

Furthermore, Mises argued (1998, p. 570), this kind of simple inflation is not likely to produce financial conditions that lead to a business cycle:

The issuance of these newly created fiat money sums does not directly interfere with the gross [i.e., nominal] market rate of interest. . . . They affect the loan market and the gross market rate of interest, apart from the emergence of a positive price [i.e., inflation] premium, only if a part of them reaches the loan market at a time at which their effects upon commodity prices and wage rates have not yet been consummated.

In other words, the recipients of the Treasury payments would tend to allocate the new money between consumption and saving roughly in the same ratio as the rest of their income. Thus, the prices of consumer goods and investment goods would rise in roughly equal proportion, and the market interest rate would not be systematically

displaced from its natural or equilibrium level. The result would be inflation, but no business cycle.<sup>11</sup>

Lastly, under this plan, the Fed would no longer function as a discretionary lender (bailer-outer) of last resort, a role that infects the entire financial system with pandemic moral hazard. No longer would the Fed be able to surreptitiously, arbitrarily, and without democratic oversight or accountability bail out all kinds of financial institutions in the United States as well as foreign countries. First, there would be no need to bail out pure depository institutions because all such institutions would hold 100 percent reserves. But, second, even if purely financial (non-money-issuing) institutions were in danger of failing, the decisions to bail them out would be made by an openly partisan Treasury under the watchful eye of the congressional opposition and in full view of the public. Financial institutions would run their affairs much more prudently with the Fed neutered and unable to leap to their rescue at the first sign of distress and with their appeals for bailouts subject to full scrutiny by a skeptical Congress and public.

This paper should not be construed as a proposal for the creation of a regime of sound money, nor should it be seen as a blueprint for a transition back to such a regime. Its sole purpose is to suggest a politically feasible solution to the urgent problem of annulling the arbitrary power of a clique of unaccountable federal bureaucrats who are destroying the US monetary system and seriously crippling the economy for years to come.

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<sup>11</sup> Even simple inflation can have devastating effects on the real economy, as episodes of inflationary war finance have shown. Military spending financed by money creation systematically promotes the production of present goods at the expense of capital goods and falsifies monetary calculation, causing the overstatement of profits. These effects result in capital consumption and a decline in living standards. Unlike the inflationary process caused by bank credit expansion, however, simple inflation will not display the characteristic "self-reversing effects" that mark the business cycle. For a detailed discussion of the economic distortions caused by inflationary war finance, see Salerno (2010).

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