End Bank Bailouts

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The banking system is confronting a crisis not unlike that during the Great Depression. In response to bank runs, the Fed is bailing out individual banks and injecting more liquidity into the banking system. The Fed has guaranteed all deposits in selected banks to prevent systemic risk to the banking system. Despite lack of agreement regarding what systemic risk means, Treasury Secretary Yellen promises bailouts to all financial institutions that pose a systemic risk (Wall Street Journal 2023). Because there is no agreement on systemic risk, Yellen says that the Fed will need to decide which banks qualify for bailouts, and which bank deposits will be guaranteed. Senator Elizabeth Warren, among others, suggests that it is time for the Fed to eliminate this distinction between banks and require the Federal Deposit Insurance Corporation to guarantee all bank deposits, in short to nationalize the banking system (Wall Street Journal 2023).

It is not clear that the Fed could bailout the banking system by guaranteeing all deposits. J.P. Morgan estimates that guaranteeing all deposits in the banking system would require the fed to lend banks $2 trillion; others have suggested a price tag of $8 trillion (Kotlikoff 2023). The reserves held by the Federal Deposit Insurance Corporation to guarantee bank deposits are a small fraction of this price tag. The only way that the Fed could cover all deposits is by printing more money. We have already experienced the inflationary impact of rapid growth in the money supply by the Fed. What Yellen and Warren are suggesting has the potential for monetary growth leading to even higher inflation. Unconstrained growth in the money supply has also resulted in unsustainable accumulation of debt (Merrifield and Poulson 2022; Poulson and Merrifield 2020; Poulson et al 2022). Before the U.S. follows the path of Venezuela and Argentina toward hyperinflation, devaluation, and default we should consider alternatives for monetary policy.

A roadmap for a more prudent monetary policy was provided by Milton Friedman. In his famous 1967 Presidential address to the American Economic Association, 'The Role of Monetary Policy', Milton Friedman laid out the foundations for an optimum monetary policy for price stabilization (Friedman 1963, 1968, 1969). He argued that to achieve price stability central banks should maintain a steady growth of the money supply in the long term, now referred to as the K percent rule.[1]

In the half century since his Presidential address, Friedman's insights into monetary policy have proven to be correct. Over the past two decades the Fed has rejected Friedman's rules-based approach to an optimum monetary policy. Discretionary monetary policies have resulted in great volatility in the rate of growth in the money supply which has been a major source of instability in financial markets. These monetary policies set the stage for bank bailouts and nationalization of the banking system.

Steve Hanke and his colleagues estimate how far the Fed's discretionary monetary policies have deviated from the k rule in recent years (Hanke 2021; Hanke and Hoffmann 2023, Hanke and Hinds 2023). They compare actual monetary policies to rules based monetary policies using Friedman's k-rate rule. Over the period 2010-2020 the actual rate of growth in the money supply (M2) was 6.5 percent, close to the k rule. However, in response to the onset of the coronavirus pandemic in 2020 the Fed increased the money supply (M2) 77.2 percent, a rate unprecedent in U.S. history. It is not surprising that this acceleration in the

[1] The k percent rule is based on Friedman's quantity theory of money MV = Py, where "M" is the money supply, "V" is the velocity of money, "P" is the price level, and "y" is real gross domestic product.

money supply was followed, with some lag, by a sharp increase in the inflation rate, comparable to inflation rates in the 1970s. Hanke and his colleague estimated that the acceleration in inflation would occur between 12 and 24 months after the increase in the money supply. Their prediction proved to be remarkably accurate. The inflation rate began to accelerate in 2021, reaching a peak of 9.1 percent in June 2022.

In response to persistent inflation the Fed has reversed course once again (Wall Street Journal 2023; Timiraos 2023). In May 2022 Chairman Powell announced a tightening money policy. By December of that year the three-month annualized growth in the money supply (M2) had fallen to -5.4 percent. Hanke (2023) estimated that this contraction in the money supply would be followed by recession, with a lag of six to 18 months. It is too early to determine if his estimate is accurate, but preliminary evidence suggests that it is. A leading indicator of recession, the annual rate of growth in final sales to domestic purchasers, fell below 1 percent, the lowest annual rate of growth in that indicator since the fourth quarter of 2010.

Friedman maintained that with the Fed committed to price stability, financial markets are remarkably resilient; but in the absence of price stability all bets are off. With the k rule in place the prescription for bank regulation is Walter Bagehot's dictum, "to avert panic central banks should lend early and freely (i.e., without limit) to solvent firms, against good collateral, and at "high rates" (Bagehot 1873). If the Fed followed Bagehot's rule it would not have to guarantee all bank deposits or bailout banks by picking winners and losers. This would preclude bailouts such as the Fed rescue of Silicon Valley bank, and First Republic bank.

Denationalization of the banking system would remove the Fed from political bias and help restore Fed independence. Milton Friedman documented the negative impact of political bias in bank bailouts during the financial crisis in the Great Depression. Friedman argued that the decision to bail out some financial institutions but not others at that time reflected antisemitism. No one is accusing the Fed of antisemitism in current bank bailouts, but for smaller banks that provide intermediation for mainstream America the political bias of bailouts is clear. The Fed rescues major money center banks, the beneficiaries of which are large corporations and wealthy individuals who hold large deposits in these institutions, deposits that were previously uninsured by the Federal Deposit Insurance Corporation. Heavy hitters in large money center banks are now saying to taxpayers, heads we win and tails you lose. It is not surprising that the beneficiaries of bailouts of large money center banks are major contributors to PACs. Investors in smaller banks are asking the obvious question, why does the Fed allow our small banks to fail and our depositors to lose their money, while rescuing investors and depositors in large money center banks.

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