Demetri Kofinas: 00:48 Today's episode of Hidden Forces is made possible by listeners like you. For more information about this week's episode, or for easy access to related programming, visit our website at hiddenforces.io, and subscribe to our free email list. If you listen to the show on your Apple podcast app, remember, you can give us a review. Each review helps more people find the show and join our amazing community. With that, please enjoy this week's episode.

Demetri Kofinas: 00:48 What's up everybody? My guest on this week's episode of Hidden Forces is Dr. George Selgin, a senior fellow and the director of the Center for Monetary and Financial Alternatives at the Cato Institute, and professor Emeritus of economics at the University of Georgia. Dr. Selgin, welcome to Hidden Forces.

George Selgin: 01:09 Thank you, it's nice to be here.

Demetri Kofinas: 01:11 It's my pleasure having you on. It seems like a very appropriate time to have you on the program given everything that's been going on, not just in markets but specifically with central banks and the Fed.

George Selgin: 01:22 Indeed, there's quite a lot happening of course, and I have never been in more demand. I'm not sure all things considered, I'm sure it would be better if this weren't so.

Demetri Kofinas: 01:35 Well, I've wanted to have you on for a while to talk about Fed policy, specifically the move to a floor system. You wrote a book called Floored. You've written many books and I actually, I don't know if you were at the Cato Institute when I was there for a conference this summer or early fall. I don't think you presented. But in any case, you've published how many books? Like 12 or something?

George Selgin: 02:02 Well, if you count the little ones, probably still not that many, I'd say maybe 10.

Demetri Kofinas: 02:08 Okay. So, for those of our listeners who may not be familiar with you, give us your background: who you are and your interest in Fed policy.

George Selgin: 02:17 Well, I like to say these days that I'm a recovering academic. I taught for 30 years. I was a professor of economics at the University of Georgia where I'm emeritus now, but also at some other schools. My first appointment was George Mason University, and most of my work has been in monetary economics, but it's been all over the board as far as that broad field is concerned. So, I like to do monetary history, policy, theory, banking stuff, et cetera. Since coming to Cato, it's been about five years now. I have of course focused a lot more on policy and events have kept me extremely busy, so it is not the relaxed pace of the academic world, but it's quite invigorating and I've certainly learned an awful lot these last few years.

Demetri Kofinas: 03:13 So I want to get into the specifics of what the Fed has announced in recent weeks, especially what it announced this week. We're recording this on Thursday, March 26th, in the afternoon after markets closed, but to kind of lead us into that, maybe you can give us your impression of where we find ourselves in today, both in terms of central bank policy and in terms of markets in the economy. What is your view on the current moment?

George Selgin:	03:45	Well, it is, as everybody now has said many times, it's unprecedented what's happening now. We've never had an event like this. It is so unusual that it's difficult to compare it with other crises. It lacks the features of some of the worst crises of the past. So, far it doesn't involve collapse of the financial industry and that's very, very important. But it does have though in its own way, a justice disturbing and many ways more disturbing is like a combination of a very severe real shock, which is the disease itself and voluntary lockdown.
George Selgin:	04:31	So they're shutting down entire economies, and it's as if you had a general strike going on sponsored by the government, you don't know how long it's going to last and it's being conducted not for the sake of the workers who are on strike, but for the sake of the health of people in general and older people in particular. And of course, when workers go on strike, somebody's got to pay them if they're going to be able to survive. And you can think of the huge relief package that's just been passed as government essentially paying, supporting the strikers and it's going to have to borrow the money and eventually it'll collect the union dues from all of us.
Demetri Kofinas:	05:21	Yeah, it's kind of like a double envelopment or a pincer movement. On one side is the government mandate to effectively shut down the economy. That's not the objective, but it's a consequence of the quarantines. And on the other hand, you have both fiscal and monetary stimulus to try and mitigate the economic impact of the health measures.
George Selgin:	05:43	That's correct.
Demetri Kofinas:	05:44	And I think, in that sense it is totally unprecedented because even if you went back to world war II, there was an exogenous. Well, I guess, yes, you could say there is an exogenous shock today, it's the virus, but we can't really compare with it because we were mobilizing to fight world war II, and we didn't shut down the economy, we ramped it up. In fact, the spending in preparation for world war II was a stimulus to the economy.
George Selgin:	06:10	Well, yes and no. If you go back and look at what was really going on in world war II, and I highly recommend the work of Bob Higgs on the war economy of that time, yes, people were kept working, not only did it not cause unemployment, but it essentially ended the unemployment of the great depression. But they were producing munitions and bombers and all kinds of war material that of course did not itself add to people's wellbeing, not directly. And so far, as it helped to win the war, that's a different story of course, but in some ways the analogy is, I'm trying to say perhaps a little closer to the current situation. Now we have people who aren't producing anything, so imagine that instead they were stockpiling bombs and then we were going to blow them all up. We'd be no worse off or better off assuming the bombs didn't hurt us, but the difference is of course that we're fighting a disease.
George Selgin:	07:12	So I think the fact is that world war II was a real drag on the economy in the sense that production was not stopped but largely reoriented away from what consumers wanted. In the present case, it's being stopped and it's not that people are producing other stuff, they are just producing less stuff and the cause is different of course, it's about the disease, it's not about fighting another country or countries. So, there are some real similarities and one of them is that one way or the other, those of us who are involved in this fight and have been

as it were drafted, not so we can go overseas and fight but so drafted to stay home as it were and never going to be getting our military pay.

George Selgin: 08:05 So you can make that comparison and it isn't as forced as you might think, but is also not forced of course, is the magnitude of the effort and there world II or something like it is probably the closest precedent you're going to get. We've never seen this kind of increased in borrowing and spending except in war time situations in the past.

Demetri Kofinas: 08:31 So in that sense, is that like sending a flow of stimulus through a broken plumbing system? In other words, in preparation for world war II, the stimulus was used to ramp up for the war. In this case, does it just create pent up demand that comes out disproportionately on the other side of this crisis?

George Selgin: 08:51 I don't think so. First of all, we should distinguish stimulus from relief. And it's difficult to do that because in Congress they've been calling the big bill that we've just seen passed. They've been calling it a stimulus bill, but it's really a relief bill. A lot of it is just borrowing against the future to keep people provided for. And it really isn't a question of stimulus, except in the sense that if we didn't get this money, many people wouldn't be able to continue to buy their necessities and all that. And of course, it's also aimed at keeping businesses alive that would otherwise fail. So, in a sense it's a stimulus, but it's a stimulus that is mainly a question of providing for the survival of businesses and industry, which is to a degree that's not in the usual case where you wouldn't have as complete a shutdown in a crisis. Most people--

Demetri Kofinas: 09:57 So it's more like a sustenance bill?

George Selgin: 10:01 It's more like a sustenance bill and it's keeping the alarm economy on life support, and it's in that sense an essential part, I think from a humanitarian perspective, given the decision that people have to stay home so others don't get infected and they don't infect themselves. So, that's the starting point of course. Once you make that decision, you're pretty much locked into, I think an obligation the government is, to see to it that if it's going to ask people to do this, it provides for their wherewithal. And the business part of it of course is mainly a question of avoiding waste because having told people to stay home, these businesses, many of them would shut down permanently. And there's really economic waste involved when you have to start over. So, many businesses from scratch and they're trying to avoid that. So, again, if you start with the health purposes of the effort, if you accept that as a starting point and a valid cause, then a lot of what's taken place since, it seems inevitable.

Demetri Kofinas: 11:13 Something I mentioned to you is, well one, I'm obviously not a health expert, but I have questioned whether or not these measures are excessive. And I'm afraid they may be because that's a pattern we've seen in the past and it's concerning because there are, as you said, there are hidden costs here, economic, social, political, there are huge political costs to what we're doing and I don't think we'll be able to really calculate the ramifications of those as well as health costs to shutting down the economy. But that's the fiscal side. What you were just discussing the sustenance bill, so to speak.

Demetri Kofinas: 11:50 Let's talk a little bit about monetary policy, the monetary side and the Fed's role in all of this. First of all, what is the Fed's role in this crisis, or at least what do you think it should be?

George Selgin: 12:04 There are three components of the Fed's role and two of them are roles it would play in any crisis and the third as well in some. And those first roles consist of maintaining the amount of liquidity in the economy that markets need to function. Making sure that there's an adequate money supply broadly and depending on who you ask, that can mean keeping spending at a certain, going at a certain rate or you can speak in terms of the dual mandate, separate components of employment and output. There the Fed's job is on the one hand to see to it that nobody is unemployed just because of a lack of liquidity and that's an important caveat. It can't prevent all that unemployment, but it's responsible for preventing unemployment due to liquidity shortages.

George Selgin: 13:04 And the other side of that is keeping an eye on inflation, making sure it doesn't get too high, but also according to its current interpretation of the mandate, making sure it doesn't get much further below its long-run target, which is 2% these days. Of course, it has had difficulty lately maintaining that 2% rate. So, those are all ordinary monetary policy, what I've just described as monetary policy in the narrow sense. And of course, that's the Fed's job. But the other part of the Fed's job is making sure financial markets don't collapse. And-

Demetri Kofinas: 13:45 Financial stability

George Selgin: 13:46 Financial stability right. We saw that as a probably the main thing the Federal Reserve was doing in 2007/2008. It was most prominently playing a role there, but it's doing a lot of the same thing now, a little bit more prophylactically you might say. It's recreated many of the kinds of lending programs that developed back in the previous crisis, but so far, it's not in response to collapsing markets, it's more to make sure that they don't collapse. It's seeing a lot of potential problems in various parts of the financial system. And that shouldn't surprise us very much to the extent that people aren't able to repay their mortgages or payback other loans, et cetera.

George Selgin: 14:34 Credit granting institutions are going to be bearing suffering from this crisis much in the same way that restaurants suffer when people don't go out to eat anymore. And it's also the case that the severe pressure on bond markets as a result of people rushing into dollars and rushing out of commercial bonds and that sort of thing, corporate bonds. All of that is stuff that the Fed has to pay attention to according to enlighten of its financial stability, maintenance mandate.

George Selgin: 15:14 So all of those things are fall under conventional monetary and credit policy. So, those are the two things that the Fed does all the time really in particularly in crisis. The other thing that the Fed is doing is heavily involved in that somewhat more controversial is assisting the treasury in its efforts to provide relief by arranging loans with treasury support, namely. And in that case, there to some extent you can say the Fed is helping to finance these expenses, but more than anything it's acting as an intermediary, making sure that the funds get to the places where they need to be. And here you have a risk that the Fed can cross a boundary line that it tries not to cross. And that's the line where it starts to

		assume risks in its lending operations instead of making sure that it's lending only good collateral and so forth.
Demetri Kofinas:	16:22	Are you talking about the liquidity facilities that it's revived than in some cases created?
George Selgin:	16:28	In some cases I'm talking about these facilities, for example, commercial paper facility, but I'm also talking about the Fed's involvement in loans to businesses, which is part of the recent legislation. Loans to airlines, loans through all kinds of businesses are provided for in the legislation. In those cases, of course the loans, they are risky, I should say. There is risk involved and credit risk and in that case the risk properly should be borne by the treasury. That is ultimately Congress should provide a backstop for it through the treasury by authorizing the treasury to do so and it has done that for many cases.
George Selgin:	17:14	The idea here is that if loans go bad, if they're risky, that ultimately comes out of the funds that the Fed delivers to Congress. Therefore, taxpayers are paying for that. If taxpayers are paying to bear risk, Congress should approve it because Congress is in charge of deciding how taxpayers' money gets spent. So, the tricky thing and the Fed is involved in risky lending is for it to arrange to not bear the risk itself, not undertake any risks without a treasury backstop approved by Congress. That's how we respect the division of powers.
Demetri Kofinas:	17:57	So there are a lot of things that come to my mind with what you said. First, I guess let's differentiate between what's in the legislation and some of these credit facilities that the Fed recently announced like PMCF and SMCCF. The first is primary market corporate credit purchases and the other is secondary market purchases. Maybe we could start with just that one because that speaks to this point about supporting the bond market and that also is expansionary in a monetary sense. But in terms of how people usually think of the Fed support of the economy, people usually think of it in terms of the banking system. But to your point, the Feds mandate includes financial stability.
George Selgin:	18:42	That's correct.
Demetri Kofinas:	18:42	Or providing for financial stability. So, how do these facilities do that? What is the purpose of these specific facilities?
George Selgin:	18:50	They are designed to maintain markets for various kinds of bonds, commercial paper. This is private securities, broadly speaking, and the reason is that these securities serve all kinds of purposes in the financial system. It isn't just a question of the ultimate borrowers being allowed to borrow and allowed to borrow on terms that are not too steep. It's also a question of maintaining the usefulness and acceptability of these securities as collateral and other kinds of credit market transactions that depend on them. It's about making sure that money market funds that invest in them don't continue to face runs as they have been.
George Selgin:	19:44	So there are many, many, many aspects of the financial plumbing that depend on the health of the security markets and the Fed is trying by hook or by crook to prop them up while the panic is taking place in particularly prop them up while the government was cobbling together its own fiscal relief measures. It remains to be seen whether the Fed can back off of this support to some extent

now that the treasury and the Congress have done their thing or some of it, but in any event, the idea was to keep credit flowing. If the credit can't flow where it's needed, then all out of these individual support programs don't accomplish anything. You've got to kind of keep the whole lubrication system operating.

Demetri Kofinas: 20:39

Yeah, I mean what are the interesting differences between this crisis and the last one is how much larger the corporate bond market has gotten from 2008 not just the shape that banks are in, which is bank balance sheets are in much better shape. But so much more of corporate funding happens through the bond market as opposed to the banking system. So, I think this explains partly the emphasis and also the extremely accommodative terms of some of these facilities. In terms of municipal credit, they've also set up some facilities and they've also set up consumer and business credit facilities. Actually, what they've done is they've actually revived the term asset backed securities loan facility and they've said they're going to create another lending program for main street businesses, but I don't think they've actually done that yet. What do you know about some of those other facilities that they've either created or they intend to create?

George Selgin: 21:35

Well, of course I'm not privy to information about the facilities that they are working on now, so I couldn't comment very much about them. What I do know is that for the second time the Fed has had to rely on a just a very long list of specific emergency facilities. It's like a new deal of credit with all of these alphabet agencies that you've named a few. But in all, there have to be at least a dozen and counting. And it did this same sort of thing in 2008 and each one of these facilities has its own distinct collateral that is the kinds of assets it's going to trade on, acquire, whether it can buy them outright or has to just borrow them or trade money for them in a temporary way. Who it can deal with, which firms are which financial firms, which nonfinancial firms and not in some cases and so on.

George Selgin: 22:38

So it's a very complicated Rube Goldberg approach to dealing with the crisis. So, I think more important than the details of the specific facilities because one could argue about the merits and problems of each. What's most disturbing to me is the fact that they've had to do all this again because they've had 10 years since the last crisis. To think about changing their operating framework to make it more robust so that ordinary standing facilities of the Fed could more or less automatically continue to function during a crisis like this or one like last time, but be more robust because they were equipped up front to deal with a broader set of counterparties to accept a broader set of collateral. And what's striking to me is that in this last decade with, even though officially the Fed was going through a massive review of its framework as they called it, they didn't change anything.

George Selgin: 23:50

We've come into this crisis more or less as we came into the 2008 crisis. The one big difference is Dodd-Frank added a few provisions that actually make it a little bit harder for the Fed to use 13(3) lending, which is lending to non-banks for example. But nothing was done to allow the Fed to respond flexibly without having to recreate emergency facilities and come up with new ones. Nothing was done to change the emergency lending facilities during the last 10 years. So, we could do something better than what we had to do in 2008. So, the response could be less ad hoc and less piecemeal. I find that quite striking.

Demetri Kofinas: 24:33 What's an example of something that could have been done in your view?

George Selgin: 24:36 Well, for example we have a long tradition in the United States, which is what put us in a bad position in 2008 of having very narrow collateral and counterparty frameworks in our system. And all of these, every aspect of the way the Fed did operated up to 2008 was based on historical factors that weren't particularly rational. So, you had this deal with the Fed could only buy securities from primary dealers so they can only deal with them for security, outright purchases and repo. Then you had a discount window that would only deal with banks. So, you had the theory narrow counterparties for one kind of lending facility, a completely different, much smaller set of counterparties for another Fed facility. And you didn't have any facilities that could respond to non-bank counterparties except what you had was a 13 (3) clause in the books. But it was something that hadn't been paid much attention to, hadn't been used much. It was there, but they would have to build facilities to make use of it, which they of course started to do in 2008.

George Selgin: 25:57 Okay, well 2008 proved that you need it a lot more than these historic arrangements. The discount window was hardly used at all because of stigma. So, we had the task, I could go down the list, but everyone knows the Fed had to cobble together a bunch of ad hoc new arrangements. After that experience, they could have looked and said, "Could we do better?" And if they had looked at Europe, if they looked at Japan, they'd look at Great Britain as well as continental Europe in the ECB, they would have seen countries where they had broad facilities where the same facility could take a lot of different collateral, could deal with a lot of counterparties and provided a lot more flexibility.

George Selgin: 26:43 And for that reason, although you had all kinds of problems in the ECB and Britain and Japan, they've all had their own problems. What they didn't have was operating systems that were very narrow and highly circumscribed in what they could do. So, they had less need for emergency facilities. They didn't have to come up with a zillion new off alphabet lending facilities for the emergency. So, we could have looked to them, the Fed could have looked to them and said, "Okay, let's just start over. Let's redo the architecture of our various arrangements. Let's think about an alternative to the discount window. Let's think about broader counter parties. Let's think about the TAF, why we just keep that it worked really well and make it part of our permanent arrangements maybe broaden it, maybe let non-banks be part of it." And so on.

George Selgin: 27:40 Anyway, this kind of thinking just didn't happen. And so here we see the Fed officials having to reinvent the wheel all over again or dust off programs they cobbled together in 2007 in a hurry. And haven't done anything to improve since that doesn't seem right.

Demetri Kofinas: 28:03 Should the dislocations that happen in the repo market last fall been a warning both to investors and to the Fed itself that they didn't have a full grasp on the interbank market and how credit markets had changed since 2008?

George Selgin: 28:20 Well, I think that's true to some extent. What they didn't have a grasp of just how many reserves, excess reserves it would take to keep this new operating system post 2008 system going. I think if we step back and ask what big thing they got wrong or one of them, I think my first answer would be they assumed that under this new system you'd have with a trillion or maybe a trillion and a half of bank excess reserves floating around, you wouldn't have any problem with liquidity. You just are taking liquidity off the table. Well, if you really believe that, then you're going to be complacent about your lending facilities, right? Because the purpose of those is to keep institutions liquid.

George Selgin: 29:10 Well, look how liquid they are. We've got a trillion, a trillion and a half, whatever. I think what they're learning and what they should have started learning as you suggested that during the repo crisis is, all that liquidity seems to be out there now many, many, many times the amount of excess reserves that banks used to make do with. But somehow, it's not doing much good. It doesn't go where you need it to go. It's frozen liquidity, so to speak. And that is not really liquidity at all. It's ice, not water. And I think that they load themselves into the belief that the floor operating system with all its excess reserves would be an alternative to an alert lender of last resort and well-functioning interbank markets. And it's just not worked out that way at all.

Demetri Kofinas: 30:07 By the floor system. You're talking about the interest paid on excess reserves putting a floor.

George Selgin: 30:13 Yes.

Demetri Kofinas: 30:14 Okay.

George Selgin: 30:14 So just to explain a little bit, the floor system is sometimes also called the abundant reserve system. There are really two names for the same thing. And the idea is that you, instead of having minimum bankers serves and banks are relying on borrowing from one another on the interbank market to make a small amount of reserves go a long way. You have a system where you try to keep them all flush with reserves all the time, so no bank has to ever go and borrow from many other, which takes more reserves but it's supposedly more reliable. Now to have a scarce reserve system, you have to not pay banks too much interest on reserves or you could not pay them any at all. That way they don't have an inclination to hoard reserves. They're always prepared to take advantage of extra reserves to offer them to other banks on the interbank market. So, that's how that system works.

Demetri Kofinas: 31:17 For those who are listening who need just a little bit more information, the Fed funds rate is the rate at which banks lend to each other overnight. And the point you're making is if you don't want to have a large abundance of reserves, then you would need to not be paying interest on excess reserves so that banks are incentivized to lend at the fed funds rate.

George Selgin: 31:37 That's right.

Demetri Kofinas: 31:38 Or increasingly incentivized to do so.

George Selgin: 31:40 That's right. You can pay them a little interest on reserves and still have a scarce reserve system, but you can't pay him too much. In abundant reserve system the central bank purposefully pays a generous interest rate on reserves, so banks will want to hoard them. And then it floods the system with reserves. And then the idea is now they're not willing to lend to each other or borrow from each other. But that's okay because they always have so many reserves what's the problem? So that's how that was supposed to work. And that's the system that was essentially stumbled into in 2008 it was not something that they were planning on. But in 2019 they decided they were going to keep it. I thought that was a very bad decision, but they decided that they liked it that way, they thought it was working very well.

George Selgin: 32:32 And so that's the system that we've entered this new crisis with. So, first thing that we know is a floor system doesn't prevent you from having a crisis that's perhaps asking too much from it under the circumstances, but it also has an added that much to the liquidity of the financial market. If it made a huge difference there, we might not have the Fed intervening quite so much for the purpose of maintaining that liquidity. So, I would say at best the floor system as far as it's the liquidity contribution at best it's been a wash. It's not been an obvious improvement and, well there you go.

Demetri Kofinas: 33:15 Also I think, and now we're kind of going down the IO ER rabbit hole, which is something that I do want to do with you, but probably I don't know if we'll have time to do it on this episode just considering the larger context, but you lose of course, the valuable information signal that comes from a repo market that's functioning properly where the interbank lending market is vibrant. If you're using a floor system, correct?

George Selgin: 33:40 Well, yes and no. The market that the floor system most obviously kills off is the Fed funds market and there you do lose the information. The difference is it's not a repo market it's an unsecured lending market. That's where banks lend to each other without security. And for many, many small banks that would be the market, that's the market they use because they have to pay extra to enter the repo market or they're just not well positioned to-

Demetri Kofinas: 34:10 Right the repo market it basically enables loans through the collateralization of capital of US treasury security.

George Selgin: 34:17 That's right. And only big banks really take advantage of that to a large degree because smaller ones don't typically have a lot of treasury securities or other liquid securities that they can repo. So, they traditionally relied on the Fed funds market for borrowings and often the big banks lent on that market rather than borrowed on it.

Demetri Kofinas: 34:43 Okay. So, at the risk of, or to mitigate the risk of straying in too many different directions and not helping listeners follow along, let's continue with this larger point from which IO ER came out, which is that we have a different monetary system today than we had heading into 2008. Conditions are different and two other important differences are not only is the interest rate much lower or was it much lower heading into the crisis, but the balance sheet of the Fed was much larger. And perceptions, I think also about the potency of Fed action were also different heading into this crisis. How do you see that? In other words, how do you think the conditions of monetary policy, the history of the last crisis, the response to the economy or nonresponsive this of the economy, the Fed policy, the size of the balance sheet, the place of interest rates. How does all of that figure into your equation about where we are today?

George Selgin: 35:45 It's a good question. It's a big question of course, in the last crisis it was a notorious that the Feds conventional way of easing monetary policy is to lower interest rates and usually it did that by just buying securities in the open market

		and that would raise the security prices and lower interest rates. It would lower interest rates mainly by creating more bank reserves to banks could lend to each other on cheaper terms. And in that crisis, of course the Fed took interest rates all the way down to 25 basis points. But before it had done that, it had introduced the floor system we were just talking about and started paying interest on reserves. And 25 basis points was as low as it set the interest rate on reserves. And then that put the bottom on things.
George Selgin:	36:40	In the current crisis, it's gone as low with interest on reserves as 10 basis points. Why it hasn't gone all the way to zero or to negative numbers isn't clear because again, conventionally the idea is you have easier monetary policy. The lower your short term interest rates are, you set a lower target, you get that target. So, in a crisis like this, you would think that the Fed would at least drive the interest rate down, set its interest rate on reserves at zero in--
Demetri Kofinas:	37:15	Were they just trying to send a signal to the market to say we're not considering going negative. We've got room to cut.
George Selgin:	37:21	I don't know. I don't know why you have to stop at 10 basis points to signal you're not going negative. You can stop at zero and signal you're not going negative if that's what you want to do. So, I don't know why the 10 I think I'll give you my cynical reason about the 10 basis points. They want to signal that they are never going to stop it paying interest on reserves one way or the other that they liked the floor system and they don't want anyone to get the impression that they're turning back the clock to before the fall of 2008 and so those 10 basis points are symbolic. Not as a way of saying we're not going negative, but it was a way of saying interest on reserves, this here to stay one way or the other. That is more likely.
Demetri Kofinas:	38:08	Does that also mean that they wouldn't take the rates negative-
George Selgin:	38:12	Well yeah.
Demetri Kofinas:	38:13	Because in that case if IOER is going to be positive, how would that work?
George Selgin:	38:17	Well, I think it's very interesting. I think the Fed, as I said, definitely doesn't want to give the impression that it's abandoning IOER altogether, but it also doesn't like negative interest rates. It is not convinced that they are worse than just settling for zero, partly because they feel that it can impact bank profits highly adversely and there's some basis for thinking so from European experience though it's controversial. But I also think that the Fed doesn't want to fight that fight. I think they don't have the fight in them to try to win Congress over to negative interest rates. They know it'll be highly controversial. So, there are all kinds of reasons why they won't go negative. But I think if you gave them a choice right now and if they were interested in going negative, I bet you would see us go from 10 basis points to negative and never stop at zero in between. That's how afraid they are at zero.
George Selgin:	39:18	That's my personal impressions. They don't want to touch zero anymore because they don't want anybody to say, "Why don't we just leave it there." And by the way, I'm not against interest on reserves. I favor a system though where the interest rate on reserves is modest and it's such that banks usually have an incentive to continue to lend to each other in the federal funds market.

		Of course, in a time like this, even if you started out with a corridor type system, we would be in the floor system now just because things are so bad. So, that is interest rates probably would be at zero now one way or the other.
Demetri Kofinas:	40:03	Just for listeners who are aren't familiar with this corridor system. By corridor you mean not paying interest on excess reserves, the corridor represents zero and the Fed funds rate that entire space is that the policy space?
George Selgin:	40:19	The U.S corridor system before 2008 was like that, but it was a little bit different. Zero was the lower bound of the corridor and the discount rate was technically the upper-
Demetri Kofinas:	40:30	The discount window-
George Selgin:	40:30	Discount window.
Demetri Kofinas:	40:30	Which is actually higher than the Fed funds rate because it's a punitive rate.
George Selgin:	40:34	That's right.
Demetri Kofinas:	40:34	So again, at the risk of going into a conversation, which I would love to have with you and which maybe we can have another time, it's actually the conversation I've always wanted to have with you and I'm not even properly prepared for it, but there sort of a couple things that come up for me. One is I want to talk about the risks, both a Fed inaction and Fed action as well as the institutional risks pose to the Fed itself. Solvency risks, I know a lot of people might be thinking, well, how's that possible? How can the Fed be and solvent as well as independence. And then risks posed to the market and the economy itself.
Demetri Kofinas:	41:08	Before we go down that route. I do have a question for you that I'm thinking listeners may be asking how can somebody from the Cato Institute be so enthusiastically in support of IOER or Fed monetary policy. Help me think about how someone like you who has his own conceptions of what an ideal monetary system would be. How do you think about the current situation given that your ideal system would look much free or in very different from the current system?
George Selgin:	41:39	So it's a good question. It's one I have had to wrestle with a lot. We have two jobs at Cato. Two responsibilities that we have to meet. One is talking about the first best, talking about what's ideal, talking about what basic reforms we would like to have occur that will move us towards a better long run monetary system. And thinking about that and writing about that, we try to be very prepared to jump out of the box so to speak, and we have a lot of writings about that. Then we have people that write about gold standard and about cryptocurrencies and we debate those things but also debate some more radical structural reforms of the Federal Reserve System that I'd like to see take places well. Even when you're talking about the long run, there are some difficult choices that have to be made. It's not as easy as in the Fed, which is a popular slogan, but it's not exactly a reform plan. It's a long way from such.
Demetri Kofinas:	42:47	It's pulling the plug.

George Selgin:	42:49	Well, it's telling people what you don't like and that's fine, but unfortunately you've got to do more than that if you're talking about reform, even if you have 100 years to do it, you've got to say what you're going to put in place of the thing you don't like and how are you going to get there. So, that's a real reform program. And it turns out that doing those things is a lot harder coming up with those things is a heck of a lot harder than saying and the Fed, particularly if you don't want people who are holding dollars to just drop dead. So, oh sorry, your dollar is not worth it. That's quite a few of us and people elsewhere than in the United States of course. So, there's a lot of difficult choices to be made and concerns to be aware of even when you're talking about long run radical reform of the monetary system which we should be talking about and we do talk about.
George Selgin:	43:42	Okay, but then there's a whole nother aspect of what we need to do at Cato to be relevant. And that is we need to be able to say right now, what should the Fed be doing? Is it doing the right thing? Is it doing the wrong thing? And saying, well, it shouldn't really exist. We really should have a gold standard, or we should have an NGDP targeting rule where by a computer or we should be using Bitcoin. None of those things are adequate answers. If you start talking that way, you're not part of the discussion. And then you have the Fed and the government just doing their own thing and you're not having any influence at all.
George Selgin:	44:20	So if we care about what they're going to do, we care about what they're doing. Let's say we don't want them to issue $2 trillion platinum coins and make the Fed accept them at face value. We can't talk about our ideals for the long run. We have to talk about that proposal and why it's wrong. And we have to talk about what they should do instead. Now, right now.
Demetri Kofinas:	44:44	So we're definitely going to talk about the platinum coin and we're going to talk about helicopter money. Something that came up is a piece of monetary history that I'm fond of, which is the story of the second bank of the United States. Andrew Jackson versus Nicholas Biddle. And that came up in my head because you were talking about end the Fed. And that was of course the end of the second bank of the United States. I think it was 1936 or 38.
George Selgin:	45:09	36.
Demetri Kofinas:	45:09	So that-
George Selgin:	45:09	Yeah.
Demetri Kofinas:	45:10	36. So, that's makes me think a little bit about the institutional risks to the Fed of action. Why don't we start with that one and then we'll get into some of the other risks of Fed action and then to Fed inaction as well. Is there an institutional risk to the Fed of action in this crisis?
George Selgin:	45:26	Oh yeah, absolutely. And the Fed is extremely aware of it. They're very aware of it. And it all comes down to the sometimes subtle boundary lines between monetary policy and fiscal policy. Where fiscal policy means exposing taxpayers to losses using taxpayer dollars for this, that, and the other thing, and we talked a little bit about it before. What the Fed is conscious of is the desire not to step on the turf of fiscal policy to involve itself in using taxpayer funds and orienting them towards this sector or that sector. Getting involved in subsidies of various

		kinds to the extent that it's perceived to be doing that. It's perceived to be invading the proper turf of Congress. Congress is supposed to determine how resources that come ultimately from taxpayers are used where they go.
George Selgin:	46:35	And so the Fed doesn't want to get involved with that. Why? Because it doesn't like power? No, absolutely not. The Fed likes power. All right? But they know that the more they get involved with that, the greater the risk that will be ultimately that Congress says, "Well, since your keeps sticking your nose in our business, we're going to have to stick our nose more in your business because you're interfering with your involving yourself in the use of taxpayer funds. That's our prerogative. So, maybe we need to regulate you some more." And when-
Demetri Kofinas:	47:13	Well, that seems like a real risk actually.
George Selgin:	47:14	Well that's exactly right.
Demetri Kofinas:	47:15	It seems like a bigger risk today than ever before. I didn't actually ever consider it as a serious risk in 2008 but it seems like one today.
George Selgin:	47:23	I think so absolutely. Because here's why it's so risky for all of us. You might say, "Well fine, let Congress tell the Fed what to do." And of course, we have a lot of people who actually feel that, that's the way we should handle things. But right now, there's only one agency in government that is responsible for regulating liquidity and implementing the dual mandate, making sure inflation is neither too low, nor too high and so forth, and making sure there's no cyclical unemployment that's due to a lack of liquidity. And ideally no booms due to excess liquidity. And that's the Federal Reserve. Congress has delegated that those responsibilities to the Fed. No one else in Congress is responsible for those things, there's no reason to think anyone in Congress is going to make decisions with those objects in mind. They're going to make them with other objects in mind.
George Selgin:	48:23	Okay. Now here's the thing. What's scary is not so much that Congress should take over control of money, but that it should do so when no one is responsible for those objectives. So, as long as the mandate is the Fed's responsibility, as long as the dual mandate is a Fed amended to the Fed, we need to let the Fed have the power and independence it needs to try and pursue it however badly it may do so. Because as bad as the Fed is, it's the only one that even officially cares about those things. No one else has that on their plate. What I see in some of the policies that have been proposed and some of the ideas of modern monetary theorists which are looking more and more influential as this crisis continues, is an attempt to change the delegation of power over money without changing the assignment of responsibility over money.
George Selgin:	49:29	That's what scary. I can imagine a world where the delegation of the power to control money is different than it is today, and that there's no Fed involved that works well. But it'll be one where there's somebody in government who is responsible for seeing to it that money is managed in a way that doesn't have cyclical consequence. So, don't tell me, "Oh, let's just get rid of all these barriers that we're abiding by that have roughly a little bit. Let's just get rid of this independence. It isn't all that complete after all, which it isn't. Let's just get rid of it all and do things differently." And my response to that is not till you show

me who's going to take responsibility for the stabilities that we care about. Because I'd rather have a system where somebody is responsible for it and they do a lousy job and then one where nobody's responsible for it and then I'm sure that it'll be a worse job. It's as simple as that.

Demetri Kofinas: 50:35 So what you're saying is it can't be that the treasury is going to be responsible for producing dollars and the Fed will be responsible for maintaining the value of that money. There's an incongruence there and in fact a great way in which that would come up would be if we were actually going to go down the platinum coin route and you had money supply expanding while at the same time the Fed was managing monetary policy and you had something like IOER now all of a sudden the Fed has to pay an increasing amount of money to banks not to lend the reserves that are in the system that were created by the treasury department.

George Selgin: 51:10 That's right. And this is a way to put that is the treasury would have the power to increase the Fed's interest earning liabilities reserves by saddling it with non-interest earning worthless assets that it can never sell platinum coins. Now, just think about that you have a balance sheet where it's encumbered by worthless coins and yet the Fed has to cover these interest expenses where the interest it pays on reserves may have to be raised to fight inflation. And the problem is the Fed could find itself in principle, insolvent in the sense that it can defer losses under its current accounting rules. It can create a deferred asset and the idea there is eventually it'll make money again so it can make up for it.

George Selgin: 52:01 But if you put enough of these platinum coins in the Fed and don't take that money, the Fed would have a negative net discounted earnings for all time going forward. And in that case, it's going to have a problem paying its bills and controlling inflation at the same time. It's going to need to go to Congress for more capital. And-

Demetri Kofinas: 52:22 Is that also a problem with negative interest rate yielding treasury securities?

George Selgin: 52:28 Well, yes and no because you see, if it's just IOER right. If the treasury securities may be bearing negative interest, but the Fed would presumably be paying negative interest on its reserves as well. You see?

Demetri Kofinas: 52:40 I see.

George Selgin: 52:41 Yeah. This is the problem with the coin is it's--

Demetri Kofinas: 52:44 We're in a really weird space here.

George Selgin: 52:45 Yeah, I know the problem that the coin is it's worthless. So, imagine, and just to take an extreme case, imagine giving the Fed three platinum coins and then suppose you gave him four platinum coins.

Demetri Kofinas: 52:59 So to be clear for listeners, now that we're talking about this, each platinum coin in this case is worth $1 trillion. It's minted by the treasury. The Fed accepts it. And in return for the trillion dollar coin, the Fed credits, the treasure's general account with $1 trillion, or in this case with four coins, would be $4 trillion. And all of a sudden, boom, the U.S government now has the capacity to spend $4 trillion and it's not liable for that money.

George Selgin:	53:23	That's right. And it never has to take the coins back.
Demetri Kofinas:	53:26	It's never issued debt. The debt, the U.S debt has not grown $1, even though the money supply has just increased by $4 trillion.
George Selgin:	53:33	It's really a $4 trillion gift from the Fed to the treasury that it can't take back. And when the treasury spends the proceeds that have been credited to its account, ultimately bank reserves go up $4 trillion. So, the Fed finds itself with these interest bearing liabilities. It's got to pay $4 trillion sum, but it doesn't have corresponding assets that are yielding flow of income. One of the modern monetary theorists said, "Okay, they could sterilize."
George Selgin:	54:02	All right. Suppose the Fed had four trillion in bonds originally just suppose. So, it sells all the bonds and reduces its reserves by four trillion. So, now it's got, instead of $8 trillion in reserves, it's got $4 trillion of reserves backed by $4 trillion of worthless coins that's its balance sheet.
Demetri Kofinas:	54:24	So just to, again, to clarify for listeners, what are you talking about sterilize? And what you're saying is if you've got $8 trillion in the system, if the Fed wants to reduce the money supply, it needs to sell assets from its portfolio. Those assets are U.S treasury securities. It has four trillion of those, it sells those mops up $4 trillion. And what's left is $4 trillion and now nothing but a bunch of worthless coins that it can do nothing with no one will accept.
George Selgin:	54:48	That's right. So-
Demetri Kofinas:	54:49	Because no one's going to buy a platinum coin for a trillion dollars.
George Selgin:	54:52	So the good news about that sterilization is it did reduce its interest earning liabilities by four trillion, but it also reduced its only interest earning assets to zero. So, now it's got a balance sheet where it's supposed to pay out, how many hundred billion every year and interest on reserves.
Demetri Kofinas:	55:08	So it's insolvent?
George Selgin:	55:09	It's totally insolvent and that's right. It'll never make up for it. And people say, we can print more money. Well you can't even to pay the expenses, it has to print money, but you can't print money to pay the interest on reserves without increasing the reserves that much more. Which means it's going to be more and it's a spiral whether it's becoming more and more negative, negative net worth and the problem is it's also increasing the rate of reserve growth so that it's not able. And this is the technical thing, they always have the infinite capacity, the print money, it doesn't have the capacity to do that to cover its interest and other expenses and control inflation. That's what the trap it can get in.
Demetri Kofinas:	55:56	So, I want to take the second hour of our conversation into the overtime Dr. Selgin, and continue our discussion about the platinum coin and maybe shift into a more proper conversation about helicopter money, which is different than debt monetization, which is what we've experienced in the last crisis with quantitative easing. I also, I want to further flesh out the risk of Fed action. One of the implications of the consumer and business credit facilities, is the purchase of riskier asset back securities, ABS and how that impacts Fed solvency. Also, the banks, the banks are in a different position today than they were in the previous

crisis. Their balance sheets have been repaired and so they're in a better position to maybe play a constructive role in supporting the economy this time around and in aiding the recovery whereas they weren't able to do that last time.

Demetri Kofinas: 56:55 And as a result that also means that they are in a position to lend to consumers and small business which means that they could incur losses on loans that they would otherwise not make because of the federal mandate. So, again, should Congress authorize a fiscal backstop? Are there any precedents to this? You've talked about FDRs promised to George Harrison of JP Morgan fame during the 1930s. So, I want to discuss those things and whatever else we can get into in the second hour.

Demetri Kofinas: 57:26 For regular listeners, you know the drill. If you're new to the program or if you haven't subscribed yet to our audiophile, autodidact and super nerd tiers, you can head over to Patreon.com/hiddenforces and subscribe. This week's rundown is enormous. I put a ton of time into it, into fleshing out some of the subjects and themes that we covered in today's conversation with Dr. Selgin and that were going to continue to discuss in the overtime. Dr Selgin, thank you so much for coming on the program and stick around, we'll be right back.

George Selgin: 57:56 Okay.

Demetri Kofinas: 57:56 Today's episode of Hidden Forces was recorded at Creative Media Design Studio in New York City. For more information about this week's episode or if you want easy access to related programming, visit our website at hiddenforces.io and subscribe to our free email list. If you want access to overtime segments, episode transcripts, and show rundowns, full of links, and detailed information related to each and every episode, check out our premium subscription available through the Hidden Forces website, or through our Patreon page at patreon.com/hiddenforces.

Demetri Kofinas: 57:56 Today's episode was produced by me and edited by Stylianos Nicolaou. For more episodes, you can check out our website at hiddenforces.io. Join the conversation at Facebook, Twitter and Instagram @hiddenforcespod or send me an email at dk@hiddenforces.io. As always, thanks for listening. We'll see you next week.