

Government adviser of 30 years' standing; academic; currency and commodity investor; published author: Steve Hanke has a long and varied CV. He talks at length to **Rob Davies** about what he sees as irresponsibility on the part of the US Federal Reserve, and his run-in with former president Bill Clinton

US monetary policy is abnormal and deviant

STEVE HANKE PROFILE

To some observers, the US Federal Reserve has got pretty much all the big calls right since the financial crisis; whether injecting liquidity into the financial sector to prevent a systemic meltdown, making emergency loans to individual institutions, introducing quantitative easing, or adopting a near zero interest rate policy.

But while others praise, Steve Hanke, professor of applied economics at the Johns Hopkins University in Baltimore and a senior fellow at the Cato Institute in Washington DC, pours scorn on the portrayal of the Fed and its chairman Ben Bernanke as the saviour of the world as we know it.

Hanke's varied career means his criticisms should not be dismissed as the ramblings of an academic who has never been involved in the political process. He served in the Reagan administration as a senior economist on the Council of Economic Advisers, and has also been state counsellor to the

Republic of Lithuania, Republic of Montenegro; and an adviser to the presidents of Bulgaria, Venezuela and Indonesia. An expert on currency boards, Hanke was involved in the establishment of new currency regimes in Argentina, Estonia, Bulgaria, Bosnia-Herzegovina, Ecuador, Lithuania and Montenegro.

In addition to his academic commitments, Hanke is a member of the National Bank of Kuwait's international advisory board and the Financial Advisory Council of the United Arab Emirates; and is also the chairman of global macro hedge fund Richmond Group Fund and chairman emeritus of the family owned, Toronto-based asset management firm, Friedberg Mercantile Group.

Hanke is particularly dismissive of the Fed's claims that the near zero federal funds rate has little impact

on anything else going on in the market; arguing it has led to a credit crunch in the domestic economy.

"It is a paradoxical situation. The Fed policy puts the credit markets in a zero interest rate credit squeeze trap because it dries up the wholesale money market," says Hanke. "No one wants to put money in and have it exposed to counterparty risk when they are almost getting paid nothing for it. Why else are banks sitting on such big cash reserves?"

The result, according to Hanke, is the "atrophy of the wholesale market", the effect of which is exacerbated by the reliance of banks on that market rather than deposits to fund loan origination.

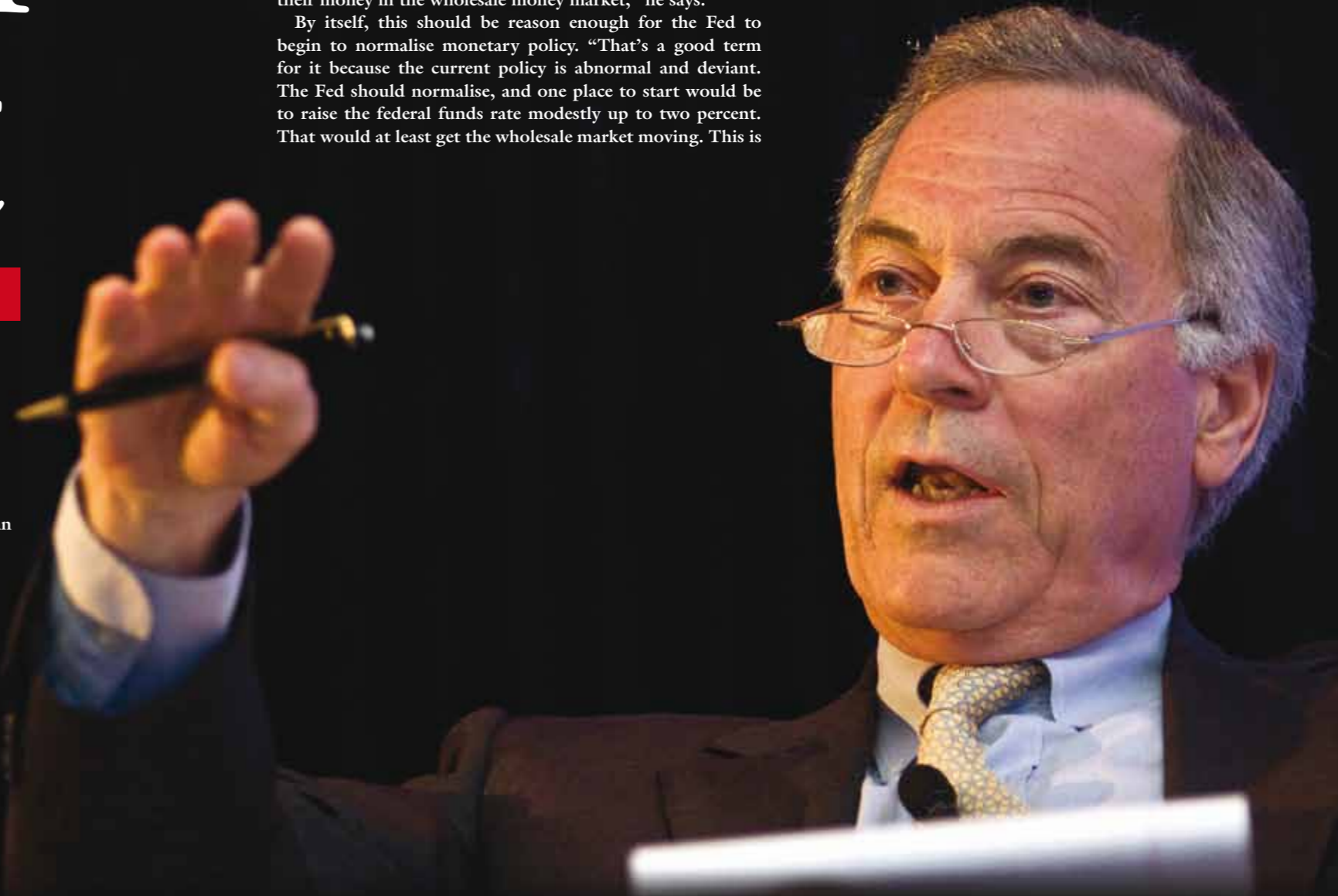
"If you can't rely on the wholesale market to fund your loans, you don't make them. That is what's going on right now. The wholesale market has shrunk since the financial crisis and also the total loans outstanding has shrunk. This is all because interest rates are so low that no one wants to put their money in the wholesale money market," he says.

By itself, this should be reason enough for the Fed to begin to normalise monetary policy. "That's a good term for it because the current policy is abnormal and deviant. The Fed should normalise, and one place to start would be to raise the federal funds rate modestly up to two percent. That would at least get the wholesale market moving. This is

a case where increasing interest rates would lead to less of a credit crunch, not more."

Yet the consequences of the Fed's monetary policy stance stretch well beyond the US, notes Hanke. "The fact is that it creates a big carry trade in the US dollar, which makes the dollar weaker than it would otherwise be. And because the dollar is the world currency, it pushes a lot of liquidity out into the international system; going into places where there are higher risk-adjusted rates of return," he says.

"That puts a lot of pressure on the foreign currencies. In order to control that, you get intervention by central banks where foreign reserves are piled up. Another effect of the carry trade is hot money flows pushing up tradable risk asset prices in various places, and also non-tradable assets like land and real estate. The reaction to that is very bad ultimately, and that is capital controls of various types."



Hanke even goes so far as to say there is a link between Fed policy, oil price hikes and the ongoing political turbulence in the Middle East and North Africa.

“Between 2002 and July 2008, the dollar declined about 45% against the euro. The contribution of that dollar weakness to the oil as well as food and raw material price increases was over 50%. And now we are seeing that occur again. In fact, the spark for the recent unrest and regime changes we have seen in the Middle East was a massive rise in food prices. The Fed has been an absolute disaster and has got away with all of this without anyone laying a glove on any of it,” says Hanke.

According to his research, about 6.2% of the average household budget in the US is made up of food; in Brazil it is 24.7%, Russia 28%, India 35.4%, China 32.9% and Indonesia 43%. In the Middle East and North Africa, that figure is 43.8% in Algeria, 38.1% in Egypt, Jordan 40.7%, Morocco 40.4%, Saudi Arabia 23.7% and Tunisia 35.7%.

“These are very high numbers, and mean that if the dollar stays weak and food prices remain high, you’ve got a lot of inflation that will come into the consumer price index and ordinary people will get hit,” says Hanke. “Food riots are not a minor issue in these countries. In June 2008, there were rice riots in the Philippines, Thailand and in Indonesia.

“In effect it works like a big increase in VAT or sales tax. Can you imagine if all of a sudden somebody told you that they were going to increase the sales tax on rice by 50%? It doesn’t take a genius to figure this out: the only one who has never figured it out is Ben Bernanke. He has testified over and over again that the US dollar doesn’t have or has very little effect on food prices and oil prices, but that is just not true,” he adds.

For this reason, Hanke says it is time to be cautious on the emerging markets, which have seen huge inflows over the past year from investors in the US and Europe. Inflation concerns may have prompted the European Central Bank to increase rates in April – a hasty decision according to many – but it is an even more pressing issue in the emerging markets. If central banks in those countries fall behind in tackling inflation, it could damage growth and see a very quick reversal of flows back to the developed world.

“If we go back a year, I found places like Indonesia very attractive. But it and some of the other emerging markets are now in trouble. The central bank in Indonesia is behind the curve in terms of fighting inflation; the same goes for India and China. So while I was very much on board with the Asia story last year, I’m out of there now because they are going to be forced to fight inflation,” says Hanke.

“Inflation comes into play in equity markets and bond markets because many central banks are behind the curve. Inflation expect-

Indonesia and the Clinton spat

Hanke’s advisory work for governments has often seen him focus on whether to install currency boards in an effort to bring economic stability. Currency boards issue domestic currency and back it 100% with foreign reserves: the local currency trades at a fixed exchange rate relative to an anchor currency, usually the US dollar.

It was while Hanke was advising Indonesia on establishing a currency board during the Asian financial crisis of 1997–1998 that he became embroiled in a heated dispute with the IMF and then US president Bill Clinton. In July 1997, Hanke helped Bulgaria install a currency board to “break the back” of hyper-inflation. At the end of that year, the newly founded Bosnia-Herzegovina was mandated to have a currency board for its first six years, as a component of the Dayton-Paris Agreement to end the Balkan wars.

Somewhat ironically in light of what was to follow, both Clinton and the IMF were proponents of the currency board idea for Bosnia-Herzegovina. Their stance on Indonesia was very different, however, and not because they had suddenly become anti-currency boards. Hanke takes up the story.

“The Asian financial crisis had completely engulfed Indonesia by January 1998: the rupiah had collapsed and there were food riots. Indonesia had an agreement with the IMF where it was to implement all sorts of reforms in return for an IMF loan. The IMF had advised Indonesia that everything would be stable if it were to float the exchange rate, which it did in July 1997. And the currency didn’t float on a sea of tranquillity; it collapsed. Inflation kicked up and food prices kicked up: things had just got extremely unstable. The Indonesians got in touch with me because they knew

tations are becoming unanchored now and inflation is going up significantly in these places. The outcome is that central banks will be forced to aggressively increase interest rates to control inflation and you know what that does to an equity market and a bond market: it puts them in the tank.”

Back to the US

Another issue starting to attract increasing attention in the media is US public debt, which reached \$14.025 trillion at the end of 2010. While Hanke describes much of the discussion on US debt as “utter nonsense”, he says the recent rise in federal government expenditure as a percentage of GDP is worth paying attention to. Federal expenditure is now at the highest level since its World War II highs; it peaked in 1945 at 47.93% of GDP. In 2009, the figure was 24.91%, and dropped to 23.82% in 2010. But it has generally risen over the past decade or so, having been at 17.98% in 2000.

“The discussion should be focused on cutting government expenditures and getting them back into a normal range of between 18.5% and 22.5%. When Bill Clinton was president, he actually had the thing driven down to 18%, largely because we had a divided government. Congress was strongly Republican and Clinton was smart enough to realise he had to play ball with

I’d been involved in Bosnia and Bulgaria, and asked me to take a second look at the IMF agreement,” says Hanke.

He concluded the only way to stabilise the situation was to install a currency board and fix the rupiah against the dollar. Hanke claims the Clinton administration also knew this would stabilise Indonesia, but opposed the move because that might keep President Suharto, the country’s leader for 31 years, in power.

“They were adamant against this and pulled out absolutely all the stops with regards to blocking this currency board idea. I remember when I was in Jakarta, we received four calls from the Clinton administration to Suharto saying, ‘If you do the currency board, you’re not getting the \$43 billion [of IMF support].’ Suharto was smart enough to know that if he didn’t install the currency board, the economic situation would be very unstable and he would probably be kicked out anyway. He even said in a state speech he was going ahead with it.

“But soon after, I got a call from his chief of staff who told me Suharto had decided to abandon the currency board idea. I was a little surprised and when I got back to Jakarta and poked around, I found out that the US had sent about half of its Pacific fleet down to Jakarta to do exercises. The military establishment in Indonesia got nervous. In a manner of speaking, they abandoned ship when it came to the currency board. But in just a few weeks Suharto got pushed out anyway [in May 1998]. The



Hanke meets Indonesian president Suharto in Jakarta in February 1998

situation remained very unstable and, interestingly given what we’ve seen in the Middle East and North Africa, at the heart of that instability was a massive increase in food prices. It took a full decade for Indonesia to return to the per capita GDP that it had in 1997 before the crisis: the country literally lost a decade,” says Hanke.

He remains adamant that the IMF and US’s stance on Indonesia was a case of politics over principles, citing their position on subsequent episodes of strife in the emerging markets as proof.

“Ironically, right after all this flap about currency boards in Indonesia, the IMF blessed a Russian currency board [after its default in 1998]. The Russians opted against it, but Michel Camdessus [head of the IMF from January 1987 to February 2000] gave the green light. It isn’t widely known, but there were also secret meetings at IMF headquarters in which Brazil was advised to put in place a currency board after its currency blew up in December 1997.

“The whole remit at the IMF was to stabilise things, and in Brazil and Russia it was nudging them in that direction [of currency boards]. Indonesia was an anomalous case, where the IMF and US did not want to stabilise anything. Even in February this year, right after the election in the southern Sudan, the IMF recommended a currency board approach,” says Hanke.

Congress if he was going to get anything done. The result was almost Victorian-style fiscal policy. The government ran a tight ship,” he says.

“The important thing is the interest expense on the debt as a percentage of GDP. That is going up very fast, almost doubling, even with these low interest rates. Given the amount of federal debt that has to roll over, if inflation starts picking up, nominal interest rates will increase. This means the rollover cost will go up rapidly and will become a big budget item,” he adds.

There is one school of thought that suggests the US government had to increase expenditure to make up for the fall in private sector activity following the financial crisis. Hanke, however, is at the opposite end of the spectrum, believing there is an inverse relationship between the level of US government expenditure and the economic health of the country.

“There is no question about it. The bureaucratic ‘rule of two’ says that to supply something in the public sector costs about two times what would be incurred by the private sector in supplying the same quality and quantity of goods or service. In other words, money put into the public sector is very inefficiently used. Productivity falls as more and more resources get funnelled into the bureaucracy. So almost by definition you’re cutting your potential

growth down below levels it would otherwise be if the government was more constrained and under control,” he says.

On this point, there is an interesting parallel to be made between the US and the coming superpower, China, which continues to report high growth despite the large role of the state in its economy. Hanke disputes suggestions that government spending is a big contributor to China’s growth.

“The areas where they have liberalised the economy and pushed it towards a more free-market regime, you get explosive productivity growth and innovation. It is those sectors that have made the big contribution to growth. If you look at the public sector, that is where you have basically a black hole and lot of resource misallocation,” he says.

“It was the same in the good old days of the Soviet Union, where all the economy was state controlled. In every place you looked, you asked, ‘My god, why do they have that factory there? Why is this thing [the infrastructure] falling apart?’ In fact, the Soviet Union fell apart for precisely the reasons we are discussing now. You don’t see that in China because it is a mixed economy, with the big incremental rise in growth due to the opening of the private sector. That has taken attention away from the waste occurring in the public sector.”

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