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# Ben on a broomstick

On Nov. 15, the editor of *Grant's* addressed the Investment Decisions and Behavioral Finance meeting at the Harvard Kennedy School. The text of his remarks follows.

Good evening, Harvard! It is an honor and a pleasure to be with you to explore the connection between witchcraft and superstition, on the one hand, and modern central banking, on the other.

I won't spend much time defining terms. Witches, as you know, cast spells, make storms and fly on goats or broomsticks to diabolical nighttime rendezvouses called sabbats. Modern central bankers override the price mechanism, conjure money from thin air and undertake to boost economic growth by raising up stock prices.

I began thinking about witchcraft in the context of central banking a few months ago. The 2012 Republican Party platform pledged a victorious Romney administration to form a commission to study a return to the gold standard. Some commended this plank, others criticized it—and some sarcastically suggested that the Republicans, as long as they were at it, might as well study the revival of witchcraft.

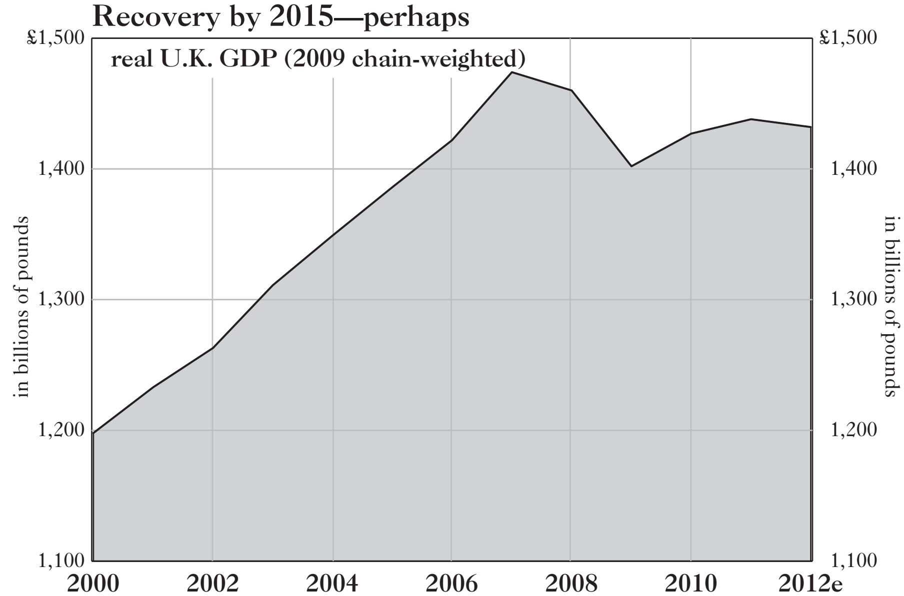
These derisive allusions reminded me of an essay by the British historian H.R. Trevor-Roper entitled, "The European Witch Craze of the 16th and 17th Centuries." In it, Trevor-Roper sends up a warning against the common presumption that the history of thought traces a straight line from the darkness to the light. Far from it, as the historian shows by citing in evidence the outbreak of "dark passions and inflammable credulities" amidst the flowering of the Renaissance.

The belief in witches was not, Trevor-Roper writes, "as the prophets of progress might suppose, a lingering ancient superstition, only waiting to dissolve. It was a new explosive force, constantly and fearfully expanding with the passage of time. . . . Credulity in high places increased, its engines of expression were made more terrible, more victims were sacrificed to it. The years 1550-1600 were worse than the years 1500-1550, and the years 1600-1650 were worse still. Nor was the craze entirely separable from the intellectual and spiritual life of those years. It was forwarded by the cultivated popes of the Renaissance, by the great Protestant reformers, by the saints of the Counter-Reformation, by the scholars, lawyers and churchmen. . . . If those two centuries were an age of light, we have to admit that, in one respect at least, the Dark Age was more civilized."

Hurricane Sandy taught a history lesson to hundreds of thousands of New Yorkers. Waking up in the cold and the dark, they suffered a kind of involuntary time travel. For days on end, they lived as their forebears had only a few generations before. When, at length, the heat and the light and the blessed cable TV connection and Internet service were restored, the unwashed and unshaven storm victims could thank their lucky stars that they live in an age of transcendent material progress.

But not all is well even in this time of plenty. Sovereign governments groan under seemingly unpayable debts. Our Great Recession, though officially end-

**Recovery by 2015—perhaps**




source: IMF

ed in 2009, continues to cast its pall over our finances, labor markets and politics. In Britain, the Bank of England speculates that output will not return to the levels of 2008 until the year 2015 at the earliest. From these manifold troubles, the world seeks deliverance through the techniques of modern central banking.

What the central bankers can do to help is not, in fact, so obvious. We Americans built too many houses and borrowed too much money to buy them. We produced too little and spent too much. A layman might suppose that to set things right a chastened people should work and save. We should mark our errors to market, restructure our debts as necessary and try to do better next time. But the layman would reckon without the theory and practice of modern currency management.

As to the theory, the highly trained economists who fix the interest rates (fix them to the point of invisibility), manipulate the yield curve and buy up hundreds of billions of dollars of notes, bonds and mortgages with newly materialized dollars profess that they know more than the market. That is their credo.

You have probably never heard a fully credentialed monetary economist profess this article of faith in just those words. The mandarins speak a language all their own, half faculty-club English and half mathematical symbols. Just how far up in the clouds are their heads may be inferred from a sample of the research papers recently produced by economists at the Federal Reserve Board:

- "From Many Series, One Cycle: Improved Estimates of the Business Cycle from a Multivariate Unobserved Components Model."
- "A Reliable and Computationally Efficient Algorithm for Imposing the Saddle Point Property in Dynamic Models."
- "Computing Dynamic Stochastic General Equilibrium Models with Recursive Preferences and Stochastic Volatility."

Formidable indeed are the intellects that create the scholarship that supports the Federal Open Market Committee in the business, not so much of central banking, but of a halfway kind of central planning. Press down interest rates by so many basis points and lift up asset prices by so many percentage points, the Ph.D.s at the Fed suggest. Hiring will restart, too, they say. Inflation will twitch higher also, but not by so much and, in any case, the scholars will not forget to reduce the rate of rise in the cost of living when the time is right. The Fed has devised an exit strategy.

This is no reformed and rehabilitated Federal Reserve. It is the same bureaucracy that somehow failed to notice the coming of the credit storms of 2008, the biggest event, bar none, in the bureaucrats' professional lives. Yet we are asked to believe that the unchastened mandarins will be any more observant come the next cyclical moment of truth.

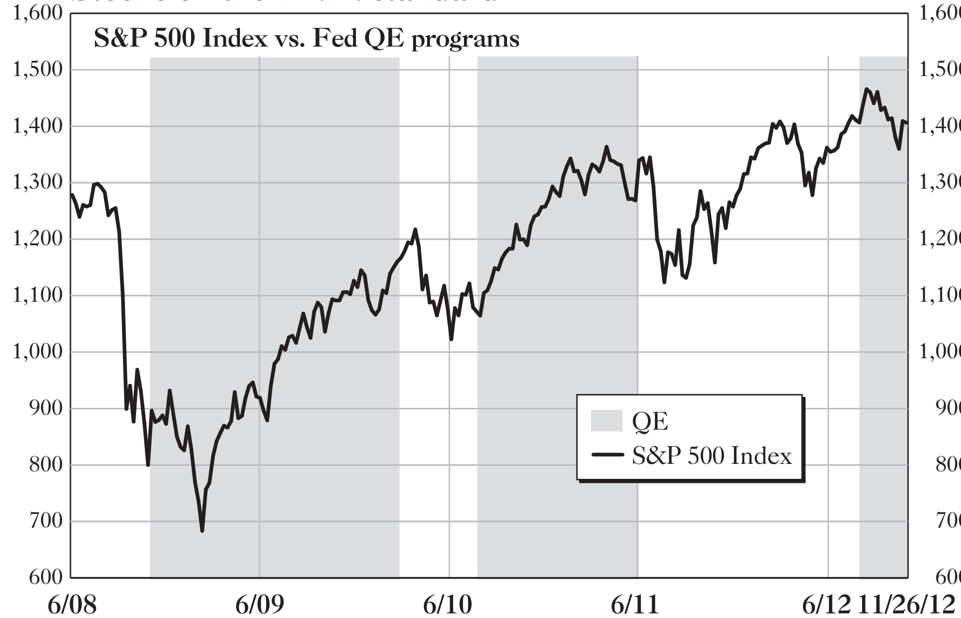
Once we had the gold standard. Today we have the Ph.D. standard. Central banks in the era of the classical gold standard—that is, in the 40-odd years preceding the start of World War I—employed no economists. They monetized no government securities. They adjusted their discount rates to assure the ease of convertibility of bank notes for gold, or gold for bank notes, at the fixed and statutory rate. The system worked as well as any human monetary contrivance has ever worked.

Then came the guns of August 1914. Came John Maynard Keynes. Came the Great Depression, fascism, communism, statism, World War II, Bretton Woods, today's pure paper dollar—and the thoroughgoing transformation of economics into an outcropping of applied mathematics. Sounding for all the world like physicists, the doctors of economics became central bankers.

Though you can hardly understand a technical word they write, the mathematical mandarins are not physicists. Friedrich Hayek, in a speech given on the occasion of his acceptance of the Nobel Prize in economics in 1974, denounced the scientific pretensions of his fellow economists. Especially did he chide them for insisting that the only magnitudes that matter are the ones you can measure. He called this error "superstition."

Now it happens that the founder of physics, Sir Isaac Newton, was a contemporary of the founder of econometrics, Sir William Petty. Imagine yourself in a London coffeehouse along about the year 1685. You know Newton and Petty. Sharp as a tack, they are. And each is on the threshold of discovery in a promising new field of thought. Imagine now that you have been returned to life. You are informed that the physicists have discovered the God particle, whereas the economists are embarked on QE3, having no real way of knowing if it will do any good—or, for that matter, if QE1 and QE2 worked, either. Plainly, physics has made a different kind of contribution to human society than economics has.

**Stocks on the Ph.D. standard**




sources: The Bloomberg, Federal Reserve

Then, again, physics is an easier nut to crack than economics. Electrons don't have feelings, as they say.

Progress in science is cumulative; we stand on the shoulders of giants. But progress in finance is cyclical; in money and banking, especially, we seem to keep making the same mistakes. Just yesterday, the deputy governor of the Norwegian central bank took a swipe at quantitative easing. If Ben Bernanke doesn't watch out, said Jan F. Qvigstad, the chairman of the Federal Reserve will go down in monetary history as the 21st century's own John Law. As you know, Law disastrously over-cranked the money presses more than 300 years ago.

What imbues money with value? The stamp of the sovereign? Or the nature of the monetary medium itself, say gold and silver? The debate is recurrent, perhaps eternal.

Anyway, the case for the gold standard is no anachronism. Those who greeted the gold plank in the GOP platform with a derisive snort perhaps failed to understand the simple elegance of a convertible currency. To use a musical metaphor, the classical gold standard is money in the key of C, the people's key. The Ph.D. standard, in contrast, is money in the key of G-flat, a key for the musicologists.

Say this for the musicologists, they don't exercise coercive power. Central bankers do, but they shouldn't. They don't know enough—can't know enough—to use it wisely, as Hayek observed. "Even if such power is not in itself bad," he continued in his Nobel Prize Lecture, "its exercise is likely to impede the functioning of those spontaneous ordering forces by which, without understanding them, man is in fact so largely assisted in the pursuit of his aims. We are only beginning to understand on how subtle a communication system the functioning of an advanced industrial society is based—a communication system we call the market and which turns out to be a more efficient mechanism for digesting dispersed information than any that man has deliberately designed."

I conclude that the Ph.D. standard, not the gold standard, is the anachronism. In this day of increasing reliance on social networks, we have, in the Federal Open Market Committee, a throwback to the command and control methods of Eastern Europe in the dark age of the 1950s. One might almost call it witchcraft.

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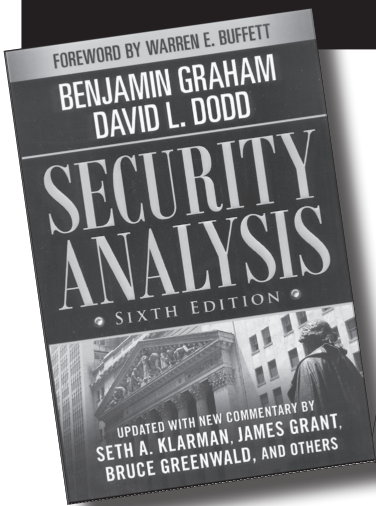


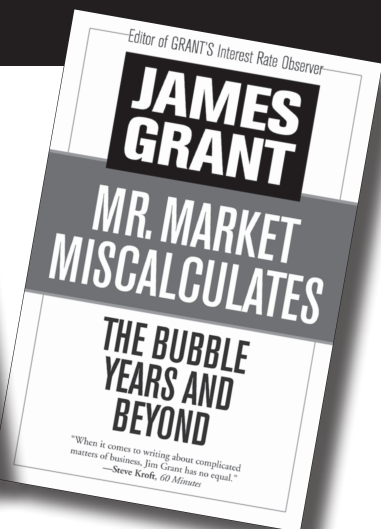



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