U.S. House of Representatives
The Honorable Ron Paul
Statement for the Record
Financial Services Committee
Humphrey-Hawkins Hearing
February 25, 2009

Mr. Chairman,

We find ourselves mired in the deepest economic crisis to afflict this country since the Great Depression. Yet, despite the failure of all the interventionist efforts to date to do anything to improve the economy, each week seems to bring new proposals for yet more bailouts, more funding facilities, and more of the same discredited Keynesian ideas. There are still relatively few policymakers who understand the roots of the current crisis in the Federal Reserve's monetary policy. No one in government is willing to take the blame, instead we transfer it onto others. We blame the crisis on greedy bankers and mortgage lenders, on the Chinese for being too thrifty and providing us with capital, or on consumers who aren't spending as much as the government thinks they should.

One aspect that needs to come to the fore once again is that of moral hazard. When the government acts as a backstop to insure losses that come about from making poor decisions, such poor decision making is rewarded, and thereby further encouraged in the future. Such backstopping took place through the implicit government guarantee of Fannie Mae and Freddie Mac, it takes place through FDIC deposit insurance that encourages deposits in the fundamentally unsound fractional-reserve banking system, and it has reached its zenith in the TARP program and its related bailouts.

When banking giants are reimbursed for their losses through redistribution of taxpayer money, what lesson do we expect them to learn? Can anyone in Washington say with a straight face that these banks will shape up their business practices when they are almost guaranteed billions of dollars in taxpayer funds? Even if this does provide a temporary lifeline, it only delays the inevitable collapse of a banking system built on an unsustainable model. Fractional-reserve banking is completely dependent on faith in the banks' abilities to repay depositors, and when that ability is thrown into doubt, the house of cards comes crashing down. The Federal Reserve may be able to manage public confidence, but confidence only goes so far. When banks are required to hold a maximum of ten percent of their deposits on reserve, the system is fundamentally insolvent. Such a system cannot be propped up or bailed out, except at the cost of massive creation of money and credit, which would result in a hyperinflation that would completely destroy our economy.

Chairman Bernanke and others in positions of authority seem to gloss over these systemic instabilities and assume an excessively rosy outlook on the economy. I believe we are at another major economic crossroad, where the global financial system will have to be fundamentally rethought. The post-Bretton Woods dollar standard system has proven remarkably resilient, lasting longer than the gold-exchange system which preceded it, but the current economic crisis has illustrated the unsustainability of the current dollar-based system. To think that the economy will begin to recover by the end of this year is absurd. The dollar's supposed strength exists only because of the weakness of other currencies. The Fed's increase of the monetary base and establishment of “temporary” funding facilities has set the stage for hyperinflation, and it remains to be seen what results.

If banks begin to lend their increased reserves, we will see the first steps towards hyperinflation. Now that the Fed has increased the monetary base, it finds itself under pressure to withdraw these funds at some point. The question, however, is when? If it withdraws too soon, banks' balance sheets collapse, if too late, massive inflation will ensue. As in previous crises, the Fed's inflationary actions leave it compelled to take action that will severely harm the economy through either deflation or hyperinflation. Had the Fed not begun interfering 18 months ago, we might have already seen a recovery in the economy by now. Bad debts would have been liquidated, inefficient firms sold off and their resources put to better use elsewhere. As it is, I believe any temporary uptick in economic indicators nowadays will likely be misinterpreted as economic recovery rather than the result of Federal Reserve credit creation. Until we learn the lesson that government intervention cannot heal the economy, and can only do harm, we will never stabilize the economy or get on the road to true recovery.