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The Poverty of Modern Macroeconomic Theory
And Power of Austrian Business Cycle Theory

By

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“I didn’t fully understand the subject...I
kept failing to understand the relationship of
microeconomics to macroeconomics [laughter].”
--Interview with Edmund S. Phelps¹

“If gold rust, what then will poor iron do?”
--Geoffrey Chaucer, *Canterbury Tales*

“Madness! Madness!” declares Major Clipton, the physician played by James Donal in the magnificent 1957 movie *The Bridge on the River Kwai*, after observing the antics of Colonel Saito played by Sessue Hayakawa and Colonel Nicholson played by

¹ Howard R. Vane and Chris Mulhern, “Interview with Edmund S. Phelps,” *Jo. Ec. Perspective*, Summer 2009, 23(3): 109.

Alec Guinness. I muttered that same phrase repeatedly in 2008 as I watched the Chairman of the Federal Reserve Ben Bernanke and U.S. Treasury Secretary Henry Merritt (Hank) Paulson create, print, transmit and guarantee trillions in unearned digital dollars for the financial powers-that-be, the insolvent of Wall Street on an unprecedented scale. Despite popular opinion strongly to the contrary, Washington, D.C. bailed out these “masters of the universe” at the expense of Main Street under the false-flag rubric of preventing “systemic collapse” and nipping “financial contagion” in the bud since “too big to fail” sounded less persuasive. The biggest moochers in history not only have survived on the dole but thrived instead of being dismembered through long-tested bankruptcy procedures. To say that their balance sheets have not been cleansed of worthless “assets” is to understate the obvious. Prepare for another round of extraordinary “rescues.”

It took me less than a day in the nearby University of Arkansas Little Rock library perusing prestigious American Economic Association publications to confirm the persistent, seemingly irreversible pathological condition of contemporary macroeconomics and its well-intended statist economists. While mainstream macro theorists continue their futile if “high-powered” displays in trying to diagnose the ongoing financial bust/downturn as well as other feverish boom/bust episodes, there is no valid excuse for their analytical failure. The business cycle is not that hard to figure out, certainly not at this late date, nearly a century after Ludwig von Mises’ breakthrough in his *Theory of Credit and Money*.²

² Ludwig von Mises, *The Theory of Money and Credit*, Indianapolis: Liberty Classics, 1980 (1912); ironically, the U.S. government approved its darling central bank birthed by big bankers the following year; decades earlier writers like William Leggett had isolated

A good rule in controversial areas is Keep It Simple Stupid; state the important facts at the beginning:

1. There is no dispute that the business or trade cycle has gone on for **several centuries** in major economies of the world, characterized by the same wavelike motion despite intermittent, self-congratulatory chatter about “a new era,” the “new economy,” the “Great Moderation,” and similar twaddle.
2. The business cycle is universally condemned as distinctly **unlovely**, something to be avoided, “cured” or solved if possible, assuming side effects would not be prohibitively costly. This yearning implies “dampening the cycle” to avoid large ups and downs, and therefore would eliminate the intoxication of the boom and bubble in addition to the corrective phase variously known as the crash, “bust,” depression and recession.
3. The “puzzling” phenomenon of the business or trade cycle has attracted some of the **ablest minds** in economics, certainly since John Maynard Keynes, so there is no lack of IQ points sleuthing the problem.
4. The **recent boom/bust episode** is an especially clear-cut, attention-grabbing **archetype** of the repetitive features of the cycle. Therefore, it should have tipped off most observers about what is going on, including our mainstream macrotheorists who typically blame “exogenous shocks”

monetary mischief as the cause of business downturns, see Thomas E. Woods Jr., *Meltdown: A Free-Market Look at Why the Stock Market Collapsed, the Economy Tanked, and Government Bailouts Will Make Things Worse*, Washington, DC: Regnery, pp. 88-94.

for a downturn. The data should almost have led them by the hand to the origin of the business cycle (on 20th Street and Constitution Avenue, NW) but apparently not. This has been the biggest, longest boom in world history ever, globally synchronized as it were, fueled by cheap credit and artificially low interest rates run amok. It's not just been "leverage," it's been an ocean of liquidity and debt come a cropper.

5. **Policy analysis** has three components: state the problem, explain its cause(s) and how the proposed policy alleviates or solves it (by addressing causes). Economists cannot openly quarrel with this statement because it applies to all human endeavor and disciplines be they engineering, medicine, or politics, yet amnesia apparently sets in when it comes to the business cycle because economists remain satisfied with fluff about pedal-to-the-metal "stimulus," more government spending (consumption) to replace consumer spending, more debt and absurdly low intertemporal prices (interest rates) obtained by any means, fair or foul.³ They essentially skip the second step and do little or nothing to lay out a coherent analysis of cycle causation.⁴

³ The architect of Great Depression II, Alan Greenspan, illustrates the loss of memory well because he wrote in 1966: "Under the gold standard, a free banking system stands as the protector of an economy's stability and balanced growth." Ayn Rand, *Capitalism: The Unknown Ideal*, p. 96, quoted in Harry Binswanger, ed., *The Ayn Rand Lexicon*, NYC: Meridian, p. 188.

⁴ For insight on the law of causation economists might consult Francis Bacon who wrote, "Nature, to be commanded, must be obeyed," in John Bartlett, *Familiar Quotations*, 15th edition, 179:10; Johnathan Edwards, "...nothing ever comes to pass without a cause." 346:5; Shakespeare's *Hamlet*, "Find out the cause of this effect, Or rather say, the cause of this defect, For this effect defective comes by cause." 220:13; Carl Menger, "All

In their haste to endorse “stabilization,” my conservative colleagues too often settle for the superficial. We may properly call them conservative in the sense that they seek to conserve what amounts to preservation of a *status quo ante* of large malinvested companies and high prices for assets and to thwart market liquidation of maladjusted capital configurations and reallocation of still-productive resources at approximately market-clearing prices. Like his economists, president Barack Hussein Obama embraces anything but “change” in the economy, as did the previous occupant of the oval office. In short, my colleagues are not radical enough in their thinking, in their science. They are anything but radical because they fail to go to the root of the problem. Failing to understand the causes of the problem, their remedies do harm. Isn’t this obvious, if only because their centerpiece—“quantitative-easing”—constitutes injection of more of the same heroin that originally misaligned the production structure with consumer valuations, especially in its longitudinal or intertemporal configuration?⁵

Following the KISS formula, what facts must any satisfactory business cycle theory account for? Murray Rothbard sums them up nicely:

First, there is the boom period, when prices and productive activity expand.

There is a greater boom in the heavy capital-goods and higher-order industries—such as industrial raw materials, machine goods, and construction, and in the markets for titles to these goods, such as the stock market and real estate. Then,

things are subject to the law of cause and effect,” the first sentence in his *Principles of Economics*, NYU Press, 1976 [1871], p. 51.

⁵ Peter Coy in *Business Week* says: “Economists mostly failed to predict the worst economic crisis since the 1930s. Now they can’t agree how to solve it. People are starting to wonder: What good are economists, anyway?” *Readersdigest.com*, 7/09, p. 19.

suddenly, without warning, there is a “crash.” A financial panic with runs on banks ensues, prices fall very sharply, and there is a sudden piling up of unsold inventory, and particularly a revelation of great excess capacity in the higher-order capital-goods industries. A painful period of liquidation and bankruptcy follows, accompanied by heavy unemployment, until recovery to normal conditions gradually takes place.⁶

What don't economists get about this picture? While it is incontestable that a financial panic occurred in 2008, some might quarrel over the contemporary validity of Rothbard's remark about “runs on banks.”⁷ The financial crisis is far from resolved today and includes over 100 bank failures and still counting in 2009; it will run into hundreds more if not thousands before the crisis is over, although runs on a wide scale have been forestalled by various means, the foremost being government interference in the form of FDIC guarantees to bank depositors ultimately supported by a central bank with a printing press. Nonetheless, an insolvent FDIC is about to eat into its \$500 billion line of credit at Treasury, which must gain the spending authority from a Congress whose 2009 spending was 42 percent financed by borrowed money.

⁶ Murray Rothbard, *Man, Economy and State*, Los Angeles: Nash, 1962, Vol. II, p. 745.

⁷ Larry Summers, former Harvard University economist and Director of the White House National Economic Council, says, “I think we got to the brink of Armageddon,” *Fortune*, October 26, 2009, p. 30. Treasury Secretary Tim Geithner says, “We were facing a classic 1930s-style run on the financial system... We spent the weekend getting the top banks and Wall Street firms together. We had them come spend the weekend at the New York Fed...the storm was so acute.” *Fortune*, September 28, 2009, p. 78.

Another fact to note before addressing causation of the latest business downturn is this: every economy is a political economy. Real economies, in other words, are an admixture of socialism and capitalism. There is no example of “pure capitalism” with well-defined and defended human rights, essentially private property rights, freedom of trade via its own commodity money, and absence of state intervention. Instead, the world is vexed by mass quantities of state intervention that interfere with free market coordination as well as trample on human rights and freedom.⁸ Hence the source or cause of “poor economic performance” may lie in state interference (sins of both commission and omission), especially in the core sector of banking and finance, and/or alleged defects in free market capitalism. Any analyst pretending to objective, scientific or “fair” analysis must concede as much. Unfortunately, too many observers need this reminder as evidenced by the fact they are eager to pin the blame for a market crash, crunch, “bust” or downturn on capitalism without explaining their logic or their evidence and why the problem cannot, instead, be traced to intervention by the state. *Newsweek*, for example, cavalierly asserts, “The current economic crisis—capitalism’s worst since the 1930s—should be a triumphant moment for Europe’s great left-wing parties, which have long warned of the dangers of unchecked markets.”⁹ Worse, economists like Nouriel Roubini say, “I don’t believe in market discipline. It doesn’t work. That was the ideology of the last 10 years; self-regulation means no regulation. Market discipline doesn’t exist with irrational exuberance and reliance on internal risk management models

⁸ A George Washington University student got moviemaker Michael Moore to admit that “we do not really have a free market” or real capitalism though economic truth eluded statist Moore beyond that admission; he cannot see that “corporatism” or fascism, the marriage of big business and big government, is the problem.

<http://www.youtube.com/watch?v=gwQ41Yo60og>

⁹ *Newsweek*, October 12, 2009, p. 9.

that don't work."¹⁰ Roubini overlooks the deeper cause of "irrational exuberance," namely, endless cheap credit policies, in favor of just writing off market discipline? And what market discipline is Roubini referring to? The Fed Plunge Protection Team? The Greenspan Put? The big banks have privatized profits and bonuses while socializing their trillions in losses at our expense. Economists do not do their homework.

Penurious Modern Macro

Invited papers presented at the 121st meeting of the American Economic Association held January 3-5, 2009 and published May 2009 in the *American Economic Review Papers and Proceedings* (AERP&P) provide a rich sample of the macroeconomic "insight" supplied by today's leading economists.

On the political left we have Alan J. Auerbach, professor of economics and law at the University of California at Berkeley and a Research Associate at the National Bureau of Economic Research (NBER), who writes, "The current recession provides compelling circumstances for renewed fiscal policy activism. But if we are going to practice fiscal discretionary policy on a large scale, then more attention to policy design is sorely needed."¹¹ So Auerbach green lights government to spend (consume) additional megabillions during Great Depression II by calling it "activism" even though it is all borrowed, mostly goes to big, politically-connected financial losers and arguably crowds

¹⁰ http://finance.yahoo.com/news/Nouriel-Roubini-Big-Crash-indexuniverse-1323647540.html;_ylt=AhDvVincHVJTHywzvKpXEvtO7sMF;_ylu=X3oDMTFhY3VxYWg4BHBvcwM3BHNIYwNzcGVjaWFsRmVhdHVyZXMEc2xrA25vdXJpZWxyb3Vi aQ--?x=0

¹¹ AER P&P, p. 548.

out investment in the productive sector. No problem apparently. Like all sophisticated political advisers, however, he cautions us that more care in spending may be advisable according to an unspecified “design,” probably a virgin design conceived by him or handed down from heaven and impervious to corruption and favoritism by powerful interest groups, Congressmen, bureaucrats, and other interested parties. By this tactic Auerbach conveniently avoids responsibility for and identification with specific political actions forcibly redistributing trillions. With powerful restraints on government like Auerbachian “design,” we are left to ponder why the founding fathers bothered with decentralized state governments, a federal republic, a written constitution enumerating limited powers, separation of powers, enumerated rights (for states too) and related frippery when they created their central state.

Opposite Auerbach on the right hand side of the mainstream spectrum we encounter John B. Taylor, professor of economics at Stanford University and Senior Fellow at the Hoover Institution, who attacks Keynesian “activism” (not labeled intervention or interference) from a monetarist/rational-expectations/“new-classical” point of view by noting data from the past decade does not support the “dramatic revival of interest in discretionary fiscal policy.” The temporary tax rebates of 2001 and 2008 failed to boost consumer spending, Taylor observes, and “experience during the past decade does not show monetary policy is ineffective.” Taylor continues,

The lesson from Japan is that it was the shift toward increasing money growth—quantitative easing—in 2001 that finally led to the end of the lost decade of the 1990s. It was certainly not discretionary fiscal policy actions. Increasing money growth—or simply preventing it from falling as in the Great Depression—remains a powerful countercyclical policy...there is no evidence

in the past decade that suggests that monetary policy has run out of ammunition and must be supplemented by discretionary fiscal actions.¹²

With friends like these, capitalism needs no enemies. Since the Japanese economy is still sick, it is impossible to credit massive money and debt inflation with ending the long L-shaped recession in Japan. The Japanese government followed all the Keynesian and monetarist advice, driving its government debt from 40 to 170 percent of GDP, and got two decades of no growth in return. Taylor nowhere identifies the cause of the recent U.S. crisis and neglects the obvious idea that the Federal Reserve Bank and the fractional reserve banking system it backstops might be the villain of the piece.

Also on the Reaganite right, Martin Feldstein, Harvard professor of economics and President Emeritus and Research Associate at the NBER, argues that estimated spending multipliers have been lower than predicted, reflecting a widespread suspicion among economists that stimulus does not work, yet says, “By the fall of 2007 it became clear to many economists that the current downturn is different from previous recessions and that monetary policy would not be effective in bringing us back to full employment.”¹³ For government to do nothing, as it did in the last so-called free market recession in 1920-21, instead of artificially lowering interest rates via inflation of money and loans and many other interventions, is not part of Feldstein’s conversation. Why markets for labor, capital and goods cannot clear rapidly and dissolve malinvestments and thereby restore sound conditions for expansion to full employment production in line with consumer wants is not stated.

¹² AERP&P, p. 554.

¹³ AERP&P, p. 556.

Along with most economists, Feldstein's discussion of the financial crisis bears the earmarks of a guy who starts in the middle of the story, thereby deep-sixing the question of the origins of the business cycle.¹⁴ He prattles on about "defaults on subprime mortgages," "underpriced risk," and "general repricing of risk caused sharp falls in the prices of mortgage-backed securities of share prices, and of the values of homes." It all sounds so Bernanke-like, droning on, pointing to peculiar aspects of this financial crisis instead of the regularities of the boom/bust cycle, stalling in order to distract from a peek at the inevitable consequences of a Fed and banking system that flooded the economy with cheap credit and low interest rates, lending new money to everyone and anyone, creditworthy or not, and expecting to avoid a reckoning down the road. "The result was a dysfunctional credit market that no longer provided credit or responded to changes in interest rates," pops out of Feldstein's Harvard-NBER magic hat. Feldstein is a top economist who serves on the NBER business cycle dating committee,¹⁵ a unit of an organization whose founding purpose was to study the business cycle, yet he fails to see that dysfunction occurred much earlier during the artificial boom and bubble, not during the financial crisis where it was merely recognized, and that a correction of the mess was inevitable, necessary and healthy, albeit painful. Nor does Feldstein consider the possibility that a true free-market correction would be short if severe—nothing moves faster than unhampered markets. Why do economists believe otherwise? Perhaps

¹⁴ This tactic follows Keynes who provided no causal theory of the trade cycle except, putting aside his numerous evasions and ambiguities, that investment spending fluctuates: the cycle "is mainly due to the [mysterious] way in which the marginal efficiency of capital fluctuates" (p. 313, *The General Theory of Employment, Interest and Money*, 1936).

¹⁵ <http://www.nber.org/cycles/recessions.html>

because they fail to study history and therefore do not know that interventions during the Great Depression enhanced duration. Can the economics profession get any more lost?

OK, it can: Feldstein perceives a GDP “gap” of \$600 billion or more “so that is the challenge: how to increase domestic spending by some \$600 billion a year in 2009 and 2010, and perhaps further into the future...so it falls to fiscal policy to support the increase in aggregate spending...fiscal policy is likely to be useful even if it is not strongly effective in 2009”¹⁶ (because Feldstein believes the duration of the downturn is likely to be long, though the cause of such agony goes unexplained!). This is straight Keynesianism.

Keynesian, monetarist, new classical, supply-sider—what’s the difference? All believe that we can spend and borrow ourselves rich via government intervention, just order up more pizza and beer. Whatever happened to Feldstein-Reagan rhetoric about getting the government out of the way and letting markets work, in this case re-coordinating a badly distorted economy? How far we have tumbled.

Feldstein is even bold enough to recommend exactly where the feds should spend newly borrowed money: “...military spending should rise...the intelligence community and FBI...NIH and NSF could allow universities and hospitals to expand ...No doubt there are other important areas of government spending in which outlays can be raised rapidly for useful activities that would also raise incomes and employment... a short-term spending surge.”¹⁷ Yeah, these government agencies are starved of funding and there is no government ratchet effect¹⁸ in Marty Feldstein’s world of policy delights because he

¹⁶ AERP&P, pp. 557-8.

¹⁷ Ibid., p. 559.

¹⁸ Robert Higgs, *Crisis and Leviathan: Critical Episodes of American Government*, 1987.

recommends a “short-term spending surge.” Feldstein backs more spending on the military-industrial-intelligence complex when the U.S. government already spends 48 percent of the globe’s military expenditures after Bush-Cheney and a toothless Congress doubled military outlays in eight years!¹⁹ I wonder if Feldstein also endorses new invasions of weak nations, more domestic spying, torture, false imprisonment, the phony war on terror, etc.?

And when the “Viagra” fails several years from now? Stay with it, Feldstein says: “Increase government spending even more...tax cuts subject to limit on growth of national debt...fall in value of dollar to eliminate today’s trade deficit...While these possibilities should be kept in mind, we can only hope that the new program of tax changes and government spending, in combination with mortgage market reforms, will be sufficient to return the economy to full employment.”²⁰ Hope, that is what the top conservative economist offers from all his recommended fiscal interference with a market correction. Among many intellectual defects, Feldstein never tells us exactly how splurging on government spending will stimulate sustainable growth in the productive sector. Government seizes the seed corn, eats it, burps and hopes farmers go forth and plant new crops. How? Muddle through? Magic?

We operate in a target-rich environment so now consider Gary B. Gorton, professor at the Yale School of Management, editor of *Review of Economic Studies* and

¹⁹ http://nomoregames.net/index.php?page=911&subpage1=why_911 On October 22, 2009 I happened to drive by the FBI complex in Little Rock Arkansas and it is colossal. But then again, its charge is public corruption so there is plenty to do!

<http://littlerock.fbi.gov/>

²⁰ AERP&P, p. 559.

according to *Wikipedia*, “a central figure in the global financial crisis of 2008-2009.”²¹ Gorton is credible because AIG—the colossal insurance recipient with some \$180 billion in unearned taxpayer receipts—paid Gorton, Hayashi and Rouwenhorst for a 2007 study of commodity futures.²² Like many economists, Gorton conveniently appears on stage to discuss the middle of the business cycle story and exclaims, “The credit crisis was sparked by a shock of fundamentals. Housing prices failed to rise, which led to a collapse of trust in credit markets.”²³ By his account, something exogenous to (outside) the U.S. political economy shocked it and thereby harmed “trust.” How fragile trust is, kind of like Keynes’ animal spirits, eh? Gorton offers up an airy allegation about market psychology to explain the episode that developed into Great Depression 2.0. Gorton does not mention what might have caused the boom (always unsustainable) in stock prices, housing prices and other titles to higher order goods.

Another prominent economist is Frederic S. Mishkin, professor at the Columbia Business School and former member of the Board of Governors at the Federal Reserve System, who fiercely defends the effectiveness of monetary policy: “... financial crises of the type we have been experiencing provide a strong argument for even more aggressive monetary policy easing than normal (p. 573).”²⁴ And aggressive “easing” (not “inflating” or printing) we have certainly had, in spades, thanks to court intellectuals like Mishkin. Recent estimates put the sum of all emergency bailouts at more than \$20 trillion.²⁵

²¹ http://en.wikipedia.org/wiki/Gary_Gorton

²² http://findarticles.com/p/articles/mi_m0EIN/is_2007_July_11/ai_n27301078/

²³ AERP&P, p. 567.

²⁴ Frederic S. Mishkin, “Is Monetary Policy Effective during Financial Crises?” *American Economic Review Papers and Proceedings*, May 2009, 99:2, 573-77.

²⁵ “U.S. taxpayers may be on the hook for as much as \$23.7 trillion to bolster the economy and bail out financial companies, said Neil Barofsky, special inspector general

Professor Mishkin, author of 15 books and numerous articles on monetary policy, is a Fed insider so we can expect little (radical) insight from him on financial fundamentals and he delivers none. No, Mishkin concentrates on policy “refinements” like “inflation targeting” within the cozy world of our beloved central planners.

An interesting footnote is that according to *Wikipedia*, in 2006 Mishkin co-authored a report called "Financial Stability in Iceland" commissioned by the Icelandic Chamber of Commerce which was responding to critical coverage of the Icelandic economy and certain Icelandic companies by international business media.²⁶ The report maintained that Iceland's economic fundamentals were strong.²⁷ Two years later Iceland experienced the 2008–2009 financial crisis, an ongoing [economic crisis](#) that involved collapse of all three of the country's major banks. “Relative to the size of its economy, Iceland’s banking collapse is the largest suffered by any country in economic history.”²⁸

Economists are nothing if not ingenious so there is more macro folly in the May *AER Papers and Proceedings* to cite though not critique in detail here. Richard J. Caballero (Columbia U.) and Arvind Krishnamurthy (Northwestern U.) refer to a “period of good shocks...[until] the end of 2006” and “if shocks turn negative—which we interpret as the post-2006 period—the foreign demand [for assets] now turns toxic; bad

for the Treasury’s Troubled Asset Relief Program.”

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aY0tX8UysIaM>

²⁶ http://en.wikipedia.org/wiki/Frederic_S._Mishkin#cite_note-1;

<http://www.vi.is/forsida/>

²⁷ Professor Mishkin’s c.v. lists the report as “Financial Instability in Iceland” (with Trygvvi T. Herbertsson), Icelandic Chamber of Commerce: Reykjavik, Iceland, 2006; so was the title “Financial Instability” or “Stability”?

²⁸ http://en.wikipedia.org/wiki/2008–2009_Icelandic_financial_crisis; also see Philipp Bagus and David Howden, “The Icelandic Meltdown,” *The Free Market*, August 2009, 27:8, Mises Institute; after costs doubled over the past year with collapse of the krona, McDonald’s decided to close its restaurants in Iceland, *Arkansas Democrat-Gazette* press services, October 27, 2008, p. 2D.

shocks and high leverage lead to an amplified downturn and rising risk premia.”²⁹ We can agree with their observation about “high leverage” (incredibly high!) but they do not identify where the credit came from, why it was there, nor do they connect the borrowed money to distortions in the capital structure (malinvestment) that consumer behavior, in effect, seeks to correct. Once again, the mainstream ignores capital theory despite its direct link to interest rates.

Tobias Adrian (NY Fed) and HyunSong Shin (Princeton U.) point to a pre-crisis world “awash with liquidity” and then bemoan a mysterious “drying up of credit.”³⁰ Befuddled, they conclude, “Balance sheet dynamics imply a role for monetary policy in ensuring financial stability...there is a strong case for better coordination of monetary policy and policies toward financial stability.”³¹ How much wronger can economists get? The very banking institutions that spawn financial instability by injecting artificial credit are charged with correcting the consequences of their interventions via “better coordination.” Adrian and Shin cannot see that the problem is brewed in the same vat as their alleged solution. Have we hit bottom yet? Perhaps it cannot get much lower than this, although Adrian and Shin are joined by the econ herd.

“Extremely accommodative monetary policy by the world’s central banks, led by the Federal Reserve,” Douglas W. Diamond (U. Chicago) and Raghuram G. Rajan (U. Chicago) claim, “ensured the world did not suffer a deep recession.”³² But who or what caused the crisis and recession in the first place? And don’t trillions propping up zombies trade off recession severity (depth) for longer duration? No response. Then we

²⁹ AERP&P, 584-88.

³⁰ AERP&P, 600-05.

³¹ Ibid., p. 605.

³² AERP&P, p. 606.

have the Diamond/Rajan policy analysis: “There are three possible ways the overhang can be reduced. First, the authorities can offer to buy illiquid assets through auctions and house them in a federal entity...A second approach...recapitalization of entities that have a realistic possibility of survival...Third, some mix of the first two...”³³ What about doing nothing? Letting the market work via bankruptcy and realistic (market-clearing) pricing all around? Forget it, not an option. Like the FASB suspending mark-to-market accounting rules in favor of mark-to-malarkey, the monetary authorities must do everything possible to cover up reality. Avert your eyes and bad things go away. Diamond and Rajan probably believe market action would be too cruel even if they believed that the overhang would thereby end quickly.

Before I beat this dead horse too much, we should conclude with three big fish: Edmund S. Phelps, Irving Fisher, and Milton Friedman. Upon receipt of the 2006 Nobel prize in economic science from the Swedish (central) Riksbank for his “analysis of intertemporal tradeoffs in macroeconomic policy,” Phelps’ home university (Columbia U.) quotes him as saying: “The problem was that I wanted to reconcile microeconomics with macroeconomics. The solution was to throw away the textbook of microeconomics.”³⁴ Do I really need to criticize this statement? Phelps could just as well have said, “My solution was to throw away the truth content we have derived from analysis of the acting individual. Instead I embrace Keynes’ fallacies about movements in aggregates.” Adding to my consternation, the press release from the Swedish Bank and Royal Academy said, “The work of Edmund Phelps has deepened our understanding

³³ AERP&P, p. 609.

³⁴ <http://www.columbia.edu/cu/news/06/10/phelps061009.html>

of the relation between short-run and long-run effects of economic policy.”³⁵ You would be sorely disappointed if you believed that Phelps had clarified the intertemporal consequences of monetary and fiscal policy in the sense of linking the impact of false (low) interest rates on the investment decisions of entrepreneurs and thereby distorting the structure of capital and production. No, Phelps stays “mainstream” (social utility functions, dynamic policy optimization, etc.) and therefore stands unsullied by capital theory and Austrian analysis even though his work deals with “the desirable rate of capital formation...foregoing consumption for investment...the savings rate...diffusion of new technology...growth,”³⁶ key issues in business cycle theory rather than compartmentalized issues for long run growth theory.

The ills of macroeconomics extend well before Phelps or Keynes’ 1936 tract, with **Irving Fisher** especially influential for the worse. Fisher’s brilliant neoclassical work on capital theory has much to recommend it; for example, Fisher insisted: “The rate of interest is the most pervasive price in the whole price structure.”³⁷ Yet Fisher’s failure as a macroeconomist is well documented and unfortunate in the extreme because he “converted the classical view of the quantity theory from a theory into a mechanism that could (and should) be manipulated in order to stabilize the value of money.”³⁸ And Fisher established no link between artificial bank interest rates, a debt-driven fiat paper money system and malinvestment. Fisher was the founder of Friedman-style monetarism and the disastrous stabilization policies of central banks.

³⁵ http://nobelprize.org/nobel_prizes/economics/laureates/2006/press.html

³⁶ *ibid.*

³⁷ *The Theory of Interest*, p. 33, cited by Henry Hazlitt, *The Failure of the New Economics: An Analysis of The Keynesian Fallacies*, Irvington-on-Hudson, NY: FEE, 1959, p. 204.

³⁸ mises.org/journals/scholar/Thornton16.pdf - 2007-01-08, p. 5.

Milton Friedman, of course, is the best known advocate of free-market economics ever, yet not when it comes to money, banking and macroeconomics where he voices no objections to central planning and “scientific management” of the economy. On this issue, he is anything but radical. On the origins of the business cycle he urges a “plucking model” of downturns in which exogenous shocks including those originating from inept management of growth of money and credit somehow push the economy below its trend line at random intervals but then equally mysteriously it bounces back up to its ceiling, self healing and returning to trend.³⁹ Yet he advocated government “pump priming” and scolded the Fed for failing to inflate sufficiently in the early stages of the Great Depression, the very “lesson of history” intellectuals like Ben Bernanke and George W. Bush take away.⁴⁰ This disastrous lesson ignores, among other things, the fact that Federal Reserve credit outstanding doubled between 1929 and 1932, the Fed cut the discount rate from 6.0% to 1.5%, conducted a massive easy money program and the “progressive” Republican president Herbert Hoover pioneered “a new field” of

³⁹ "The 'Plucking Model' of Business Cycle Fluctuations Revisited," *Economic Inquiry*, April 1993, 171-77. See Garrison's discussion in *Time and Money*, pp. 222-4, 235-9, 243. Kevin Hassett of the American Enterprise Institute takes heart as follows: “If, however, panic drives everyone to stop buying just about everything, then buying will resume when the panic subsides, and we could easily -- and quickly -- end up back where we started. A panic like that would fit the bill for a Friedman ‘pluck.’ So if the economy is going to decline, it’s good news to find out that it’s been plucked. That means a snap-back is imminent.”

http://www.bloomberg.com/apps/news?pid=20601039&refer=columnist_hassett&sid=aeHgUQWKHL3Y. Once again, it’s all about aggregate spending and little else.

⁴⁰ Kelly Olsen, “Coordinated action rescued global economy, Bush says,” AP story, *Arkansas Democrat Gazette*, October 15, 2009, p. 1D, 6D. Christina Romer, chairman of the White House Council of Economic Advisers, told a congressional panel that a lesson of the Great Depression is to “beware of cutting back on stimulus too soon.”

http://www.bloomberg.com/apps/news?pid=20601070&sid=atf_2mZ2XQKw&refer=home

intervention.⁴¹ In a fractional-reserve, debt-based international monetary system, however, an elastic supply of money and credit is a two-way street that implies money supply shrinkage as loans decline during a contraction despite Fed purchases of paper “assets” to inflate the monetary base enabled by its printing press. “Likewise Friedman (1997) joined Paul Krugman in condemning the Bank of Japan for not doing enough monetary inflation to drive it out of its economic malaise during the 1990s despite the Bank’s zero interest rate policy,” observes Mark Thornton.⁴²

The Power of Austrian Business Cycle Theory (ABCT)

The annals of the physical sciences contain examples of promising theories and data being ignored or ridiculed for substantial periods of time. Gregor Mendel, for example, was the father of genetics via his pea experiments but his work was rejected and forgotten for nearly a half century;⁴³ continental drift theory was unrespectable for even longer until evidence accumulated on its behalf and plate tectonics provided a causal mechanism.⁴⁴ Yet the neglect of the Austrian theory of the business cycle seems unrivalled in science. Even Hayek’s 1974 Nobel Prize in Economic Science aroused no mainstream interest in ABCT.

Before commenting further on why a superior theory fails to displace the inferior,

⁴¹ Murray Rothbard, *America’s Great Depression*, NYC: Richardson & Snyder, 1963, 1972, p. 186.

⁴² Thornton, op.cit., p. 12; for a summary of the recent Keynesian resurgence among economists see http://en.wikipedia.org/wiki/2008–2009_Keynesian_resurgence.

⁴³ http://en.wikipedia.org/wiki/Gregor_Mendel

⁴⁴ http://en.wikipedia.org/wiki/Continental_drift

we must state and evaluate the Austrian business cycle theory.⁴⁵ This has been done countless times but the studied ignorance of most economists suggests it must be restated and applied many more times before they learn and ABCT moves from the fringe to dominance. Arrogant economists bear a heavy burden for policy madness because, preoccupied by their mathematical models, they have failed to heed the Austrian Business Cycle Theory (ABCT) and therefore the profession provides no barrier to fiscal and monetary insanity. The determined ignorance of most economists reminds me of a cartoon which showed two men watching a Soviet May Day parade bristling with missiles, tanks and soldiers, and one asked, “Who are those guys marching in their business suits?” “Oh, those are economists,” his friend replied. “You’d be surprised at how much damage they can do.”

ABCT is scientifically successful because in a field littered with macroeconomic-model failures, it is the only theory of business fluctuations based on individual behavior and relative prices.⁴⁶ Even the most celebrated economists of all time like Irving Fisher and Milton Friedman never “got it” because although they focused on individuals and prices in their microeconomic or price theory, they largely dispensed with these in their macroeconomic or money theory. The “quantity equation” (an identity that aggregate spending equals aggregate income/receipts) is example enough. Because of their influence, what amounts to the Fisher-Friedman “separation theorem” between the micro and macro realms of thought, similar to that of Keynes, has produced immense, avoidable suffering.

⁴⁵ For an Austrian treatment that incorporates the classical “subsistence fund” in the hands of businesspeople, see Larry Sechrest, “Explaining Malinvestment and Overinvestment”: http://mises.org/journals/qjae/pdf/qjae9_4_4.pdf

⁴⁶ This section based on <http://www.lewrockwell.com/reynolds/reynolds18.html>

Virtually all economists, Marxists aside, acknowledge that prices have heavy lifting to do, at least when it comes to micro matters. Prices transmit information, provide incentives to consumers and producers to follow this information via impact on profit and loss, and coordinate equals harmonize equals dovetail the actions of buyers and sellers in the marketplace. And what if crucial prices are false? Put aside temporarily deranged market prices—they are continuously being corrected with re-pricing driven by profit and loss, shortages and surpluses—and consider prices deliberately distorted for extended periods of time. False prices must cause trouble (apparently denied by extreme rational expectations theorists and socialist planners) and it must be huge in the case of interest rates because the intertemporal coordinating mechanism is thereby jammed. Where would such persistent and pervasive deception come from? One guess: government intervention.

Virtually all economists from Fisher (quoted above) to Rothbard agree that interest rates are pervasive and critical in directing resource allocation in the economy: “It is clear that the rate of interest plays a crucial role in the system of production in the complex, monetary economy.”⁴⁷ Interest rates in a free market are determined by time preferences: if agents voluntarily increase their savings, then they sacrifice marginal spending on current consumption for the opportunity or promise of higher future consumption. They become more “future-oriented.” These actions increase the supply of loanable funds and these, in turn, lower the interest rate below what it otherwise would be. Since the interest rate regulates the temporal order of choice of investments in accordance with urgency, a lower rate signals that more projects, especially projects with more distant payoffs, are

⁴⁷ Murray Rothbard, *Man, Economy and State*, Vol. I, p. 319.

viable, that is, can be profitably undertaken. This sequence constitutes healthy coordination via the price system among savers, investors, and entrepreneurs and induces a production/capital structure in harmony with the longitudinal (intertemporal, time-dated) structure of consumer demand.

Why can't economists understand this? They agree that consumers in the short run direct economic activity by their buying and abstention from buying, thereby rewarding and punishing entrepreneurs and residual claimants. So admittedly "in the cross section" or "at a point in time" footloose consumers rule: they are "sovereign" because they have the last word on solvency. "The captain is the consumer," Mises wrote.⁴⁸

Yet establishment economists fail to perceive the same mechanism at work controlling the temporal structure of production. Entrepreneurs must please customers over time, not just in the short run. Anticipated yield sets capital (asset) values and yield is determined by consumers buying and non-buying. The blindness we observe about consumer control of the capital structure stems, of course, from economists' failure to have a capital theory in the first place in their myopic, labor-centric view of the business cycle and macroeconomic policy.⁴⁹ In the interests of "simplicity," the profession mistakenly assumes time and capital away as inconsequential for short run macro analysis, waving their *ceteris paribus* wand, despite centrality in business cycle theory.

Now suppose "wise" central planners (the Fed and its bank cartel brothers around the world) get into the act. "All present-day governments are fanatically committed to an

⁴⁸ Mises, *Human Action*, p. 270.

⁴⁹ Even MIT's Robert Solow partially recognized this deficiency in 1997: "One major weakness in the core of macroeconomics is the lack of real coupling between the short-run picture and the long-run picture. Since the long run and the short run merge into one another, one feels that they cannot be completely independent." Cited by Roger Garrison, *Time and Money*, Routledge, 2001, p. 3.

easy money policy,”⁵⁰ under color of pervasive propaganda about the public interest of course. The Fed’s cheap credit policies on behalf of the big bank cartel induce entrepreneurs to undertake previously unprofitable projects, especially lengthier, capital-intensive projects, for example, new mines, technology, R&D, casinos and housing developments. The Fed creates credit out of thin air, unbacked by an increase in voluntary savings, thereby misleading everyone about time preferences but especially entrepreneurs and investors. The appropriate saved (unconsumed) resources are not available in the form of investment to complete all of the future-oriented business projects undertaken. Households never altered the urgency of their time preferences while lower interest rates and new loans falsely signal society wants to trade off marginal near-term consumption for higher future consumption.

Credit expansion does not bump up total investment, putting aside the peculiar case of so-called “forced saving” which stems from shifts in income toward those with lower time preferences, because it still must flow from an unchanged or even smaller flow of savings which always equal the flow of investment (including inventory changes) *ex post* if not *ex ante*.⁵¹ Meanwhile, cheap interest misdirects investment into wrong projects that cannot pay off.

None of this is hard to understand or outside standard economic theory, so economists stand guilty as accused. The economy is discoordinated, inconsistent, at war with itself as Roger Garrison (Auburn U.) puts it.⁵² Attempts to hasten economic growth on the cheap, expand wealth unbacked by real savings, must prove self-defeating. It is an

⁵⁰ Mises, *Human Action*, Scholars edition, Auburn AL: Mises Institute, p. 570.

⁵¹ Rothbard: “Clearly, bank expansion cannot increase capital investment by one iota. Investment can still come only from savings.” MES, p. 857.

⁵² Roger Garrison, *Time and Money*, Routledge, 2001, ch 4.

unsustainable and incredibly wasteful situation. Karl Marx could have rightly screeched that an artificial boom (not capitalism) “produces the seeds of its own destruction,” or the mixed economy “produces the seeds of its own destruction.” Businesses overinvest in higher stages of production, as Austrian-style economists say, and underinvest in lower stages, misled and seduced by artificially low bank rates. In the absence of government bailouts, consumers ultimately order malinvested businesses to head for bankruptcy. The market reacts to Fed cheapening of the free-market interest rate by reverting to a higher market rate: “This process—by which the market reverts to its preferred interest rate and eliminates the distortion caused by credit expansion—is, moreover, the business cycle!” explains Murray Rothbard, who called it a “distortion-reversion” process.⁵³

The 2008 meltdown came when Wall Street gradually caught on that all was not well on Main Street. Main Street (= real economy) failures preceded Wall Street’s, not vice versa, as most commentators believe. Depression is the next stage as malinvested businesses, especially higher stage companies, go bankrupt and land, labor and capital shift back to lower stages of production, realigning themselves with consumers wants. Liquidation of unsound businesses, “idle capacity” of malinvested plants, and unemployed resources must shift to lower stages of production, painful though necessary it is to bring the production structure into line with consumer wants.

The deception orchestrated by the Fed and big commercial banks during the biggest bubble in history seduced businesses into overinvesting in capital goods industries, contrary to (overconsuming) consumers’ wishes. The crisis reveals a cluster of

⁵³ Murray Rothbard, *MES*, p. 859. Swedish economist Knut Wicksell was the first major economist to highlight the discrepancies between market (bank) and natural (social time preference) interest rates. Mark Skousen, *The Making of Modern Economics*, M.E. Sharpe, 2001, ch. 12.

entrepreneurial error that could not occur in a free economy. The wasted saving and investment squandered in bankrupt businesses is appalling, akin to the wastes of war.

Conventional business cycle theory cannot get much further off target. Maybe the worst part is that “depression expert” Ben Bernanke is clueless, virtually guaranteeing a depression. As I wrote in March 2006:

Bernanke's paper trail tells us...he fears falling money prices as the biggest risk of all, so he stands ready with ‘an invention called the printing press’ to combat this evil. He promises faster inflation [er, ‘quantitative easing’] in response to the next financial crisis, supplying the ‘liquidity’ the system needs...Mr. Ph.D. does not understand why a bust happens. That makes him extra dangerous. Every bust is caused by the preceding boom and its [credit-driven] excesses. The bust is curative...When Bernanke fights the market by injecting new credit in the next crisis he will sustain unsound debt, weak debtors and lousy companies, prolonging depression. That's the opposite of “putting it behind us.”⁵⁴

Bernanke fights the market and props up zombies and cannot win, though he might destroy us in the meantime.

To round out our understanding, a superb authority to consult is Jesus Huerta De Soto, a prominent Spanish economist and author of a 876-page tome on *Money, Bank Credit, and Economic Cycles*⁵⁵:

The fact that new crises erupt every few years shows that they originate from the credit expansion process, which necessarily sets off the spontaneous readjustments we have studied. In the absence of credit expansion, economic crises would be specific isolated events which would result only from unusual phenomena of a physical sort (poor crops, earthquakes, etc.) or of a social sort (wars, revolutions, etc.). They would not arise regularly, nor would they be as geographically widespread as they are. (all excerpts from pp. 456-66).

Specifically it is necessary to highlight the way in which the current monetary system, based on credit expansion, has made it customary for booms and crises to disturb economic development. In other words, it appears as if 'manic-depressive' behavior were required of a market economy.

Indeed businessmen, journalists, politicians, union members, and economic agents in general have come to consider the artificial expansionary phase

⁵⁴ http://nomoregames.net/index.php?page=economics&subpage1=prince_of_paper

⁵⁵ *Money, Bank Credit, and Economic Cycles*, Auburn AL: Mises Institute, 2006.

characteristic of a boom to be the normal stage of prosperity, which should be sought and maintained in any way possible. By the same token, expansion's inevitable consequences, i.e., crisis and recession, are considered a very negative stage which should be avoided at all costs.

De Soto is especially insightful on the stock market during boom/bust, arguing that "it is a grave error to believe real wealth is destroyed by the stock market crash which announces the crisis. On the contrary, the economic destruction takes place much earlier, in the form of generalized malinvestment during the previous stage, the credit boom."

On the craziness of the boom De Soto writes:

Economic agents do not recognize the recession as the inevitable result of artificial expansion, and they fail to realize it has the virtue of revealing the errors committed and facilitating the recovery and readjustment of the productive structure...Moreover the new money created via the expansionary granting of loans is used to finance all sorts of speculative operations, takeover bids and financial and trade wars in which the culture of short-sighted speculation prevails. In other words the misconceived idea that it is possible and desirable to accumulate astronomical profits with astonishing ease and swiftness spreads...

And the cycle never ends because of the prevailing *gestalt*:

Furthermore as any deviation from artificial expansion and the excessive optimism it produces is viewed unfavorably, immediately attacked by the media and used as a political weapon to be hurled by the opposition, unions and business organizations, no one dares to condemn the evils of the credit policy. This creates an environment of monetary irresponsibility ["Greenspan Put"] which tends to aggravate problems and makes it highly unlikely they will be resolved through a sensible readjustment and liquidation which lay the foundations for a sustained recovery that does not depend on credit expansion.

And the cycle never ends because:

...each expansion process is invariably followed by a painful stage of readjustment, which is the ideal breeding ground for justifications of subsequent state intervention in the economy and 'proves' the necessity for the state to intervene more in the economy at all levels to mitigate the consequences of the recession and prevent further crises...these interventionist policies only serve to prolong and aggravate the recession, and to hamper the necessary recovery. Sadly, the timid beginnings of the recovery are accompanied by such public pressure in favor of new credit expansion that expansion begins again and the

entire process is repeated. As Mises eloquently concludes: "But the worst is that people are incorrigible. After a few years they embark anew upon credit expansion, and the old story repeats itself."

De Soto remarks about the speculative mania (or 'irrational exuberance') in the stock market:

...uninterrupted stock market growth never indicates favorable economic conditions. Quite the contrary: all such growth provides the most unmistakable sign of credit expansion unbacked by real savings, expansion which feeds an artificial boom that will invariably culminate in a severe stock market crisis...it is impossible to determine in advance exactly when and under what specific circumstances the artificial nature of the expansion will become evident in the stock market, ultimately setting off a crisis. However the stock market will definitely offer the first sign that the expansion is artificial and 'feet of clay,' and then quite possibly, the slightest trigger will set off a stock market crash. The crash will take place as soon as economic agents begin to doubt the continuance of the expansionary process, observe a slowdown or halt in credit expansion and in short, become convinced that a crisis and recession will appear in the near future. At that point the fate of the stock market is sealed...the credit expansion process inevitably provokes a crisis and readjustment period, during which much of the book value of banks' assets evaporates (463).

Now let's get radical. The mainstream intuition that something is terribly corrupt in the relationship between banks and government is surely right but the prevailing diagnosis is wrong. The public and mainstream economists overlook the fact that forcible intervention can take two forms:

- 1) overt government interference, or
- 2) grant of privilege or immunity.

The latter technique—exemption from traditional legal principles—eludes most observers and hence its consequences are easily misdiagnosed. Exemption of banks from traditional legal principles—also known as common law—by government for its own greedy purposes is the deep source of regular financial crises.

Bankers have throughout history violated traditional legal principles in

“mishandling” so-called demand or checkable deposits. Bankers have betrayed contract law and their role as agents acting on behalf of their principals, depositors, by using most of the money on "deposit," i.e., posited or placed with them for immediate use, for their own profit. Bankers retain only fractional reserves to back demand deposits, usually under 10 percent of deposits. That is why Rothbard properly says that banks are inherently insolvent all the time.

The temptation to abuse the trust and money of depositors is irresistible to bankers. "No one may enjoy the privilege of loaning something entrusted to him on demand deposit," writes de Soto. I pay a storage facility to safeguard my RV trailer "toy hauler" and I want it available on demand, not rented out by the storage owner for his own profit. That would be an abuse of our "demand deposit" contract, and therefore would violate the principle of safekeeping. The same is true of bankers' reserve policy of less than 100-percent against demand deposits, but the fungibility of money helps them get away with it.

How do bankers get away with such fraud? Governments grant a variety of immunities: from civil law suits for itself ("sovereign immunity"), to industry for its various harms in the name of industrial development and jobs, charities like the Red Cross in the name of charitable development, and unions in the name of worker power against greedy employers. The exemption for deposit banks from traditional moral and legal principles is the most destructive immunity of all because it is the source of credit inflation unbacked by voluntary savings. This breach in the legal structure of the so-called mixed economy, with its elastic supply of money and credit on behalf of the bank cartel, can be termed a failure of society's regulatory mechanism, though not in the

manner leftists and "centrists" insist. "Far from endeavoring to scrupulously defend property rights, they [governments] supported bankers' improper activity almost from the beginning and granted exemptions and privileges in order to take advantage of this activity for their own uses." This is the hidden source of "the legally corrupt origin of fractional reserves in monetary bank deposits," Professor de Soto writes.

This radical yet true diagnosis of cycle causation leads to the right policy prescription (pp. 811-12):

- 1) ensure complete freedom of choice in currency, based on a metallic standard (gold) which would replace all fiduciary media [demand deposits presently unbacked by physical money] issued in the past;
- 2) establish a free-banking system with no central bank⁵⁶; and most importantly,
- 3) insist that all agents involved in the free-banking system be subject to and comply with traditional legal rules and principles, especially the principle that no one, not even a banker, can enjoy the privilege of loaning something entrusted to him on demand deposit (i.e., a free-banking system with a 100-percent reserve requirement).

I wait for the day when one of the frequent "summits" to solve the global financial crisis invites Professor de Soto to present his radical analysis.

The most mind-boggling aspect of the ongoing, disastrous Keynesian interventions is the collective failure to learn from past experience. Professional economists are the most guilty parties of all. For years dominant professional opinion held that postwar prosperity, although characterized by mild downturns, was a Keynesian *tour de force*. Then its reputation was besmirched by the "stagflation" of the 1970's, an inexplicable

⁵⁶ Now effectively promoted in the public square by Ron Paul and his new book, *End the Fed*, NYC: Grand Central, 2009.

phenomenon under basic Keynesian theory, plus dissatisfaction with the incoherence and ad hoc nature of Keynesian and neo-Keynesian theory. Today it seems as if none of that happened and Keynes is back, bigger than ever.

But have we misunderstood Keynes? Not at all. In his watershed 1936 book, *The General Theory of Employment, Interest and Money*, he argued that classical analysis did not apply to "the economic society in which we actually live, with the result that its teaching is misleading and disastrous" (p. 3). The cause of depression, Keynes concluded, is that "effective demand is deficient" (p. 380). Keynes dismissed blaming overpriced labor for mass unemployment as well as distorted pricing fueled by credit expansion as the cause of malinvestment. He explicitly denounced "competitive wage-rate reductions" and competitive international wage cutting. He claimed the world would not "much longer tolerate the unemployment which, apart from brief intervals of excitement, is associated — and, in my opinion, inevitably associated — with present-day capitalistic individualism" (p. 381). He found that "a somewhat comprehensive socialization of investment will prove the only means of securing an approximation to full employment" (p. 378), perhaps like the banks, AIG, GM and Chrysler?

Prices performed no explicit coordination role in Keynes's theory aside from an interest rate that might bring saving and investment into equality, though not necessarily at a full employment level. According to Keynes, investment must be stimulated to the point that corresponds to full employment through low-interest rate policies—sustained, artificially low interest rates.

Many authors have cited the Great Depression and post-1990 Japan to show that Keynesian "remedies" not only fail to restore the market economy back to full

employment health but deepen the illness. Equally instructive is the conversion from a U.S. wartime economy that took place from 1945 to 1947. The full story is available in the pathbreaking book, *Out of Work: Unemployment and Government in Twentieth-Century America* (1993) by Richard Vedder (Ohio U.) and Lowell Gallaway (Ohio U.). Toward the end of WWII Keynesian economists predicted a severe postwar depression once the “stimulus” of government spending on warfare ended. Fiscal policy swung dramatically from "stimulus" to "contraction" in Keynesian terms. The 1945 deficit was a staggering 22 percent of GDP, equivalent to \$3 trillion today, and the deficit had been even higher at 28 percent of GDP in 1943. During 1947—49, however, there were budget surpluses. By the first quarter of 1946, government purchases dropped by two-thirds. Overall, federal spending plunged from \$93 billion in 1945 to \$55 billion in 1946 and \$35 billion in 1947.⁵⁷ But the predicted depression never came; there was, instead, a rather smooth adjustment to peacetime full employment. Common predictions of 9 million unemployed turned out to be four times too high.

Keynesian economists then devised an *ad hoc* explanation — a "pent-up" demand for consumer goods — to account for the smooth adjustment to plunging government spending and expanding peacetime employment and production. Households supposedly spent and consumed America rich. How? Based on an inversion of Keynes's corrupt statement of Say's law of markets: namely, "demand creates its own supply." Yet the facts refute this interpretation. Between 1944 and 1947, personal consumption expenditures only replaced one-quarter of the decline in so-called autonomous expenditures — that is, the sum of government purchases of goods and services, gross

⁵⁷ The M2 money stock doubled in only four years during WWII, grew a modest 15 percent over the next two years (1945-47), and remained flat through 1948-50.

private domestic investment, and net exports. Consumption spending remained below predicted levels all the way to mid-1947 after demobilization and conversion from military to civilian production had been virtually completed. Furthermore, to state the obvious, consumption precedes production only in the dictionary. Consumers cannot purchase goods that do not exist or have not been produced. Before revival of mass production and sales of civilian goods, producers had to convert from wartime to peacetime manufacturing and production, that is, they had to invest.

Why was the transition so smooth? Keynes's prescription to spend ourselves rich is not only contrary to common sense but the facts and proper economic theory. A classical or Austrian analysis highlights three causes for postwar conversion:

1. Government retreated and thereby freed up the price system to perform its coordination function.
2. Government swung from massive, wasteful spending and borrowing to a smaller wastrel (temporarily) and even a net saver-lender, thereby reducing interest rates and stimulating a civilian investment boom.
3. Real wage rates fell, stimulating civilian reemployment because labor's "price was right."

I leave it to the reader as an exercise to apply the lesson of the 1940's to the consequences of today's "stimulus" (zombie) policies and their conceivable if unlikely cessation. Keynes was right about one thing: "The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else." Keynes and his intellectual heirs today are resounding proof of the power of wrong ideas.

A Philosophical Conclusion

Economists remain lost in the Keynesian jungle and the likes of Irving Fisher, Milton Friedman and Martin Feldstein have not helped. The scandal is that few sound the alarm over the abject failure of Keynesian and monetarist policies to “cure” business downturns in trial after trial. In blinkered fashion the economics profession ignores the business cycle theory pioneered by Ludwig von Mises and deepened and widened by successors like Murray Rothbard and Jesus Huerta De Soto. How economists can believe absurdly low interest rates and cheap credit unbacked by real savings do no harm to resource allocation is beyond me. “Without a sound capital theory, macroeconomics is incomprehensible,” wrote Larry J. Sechrest.⁵⁸ When will economists do their homework? Probably never because, for one thing, they lack what Larry J. Sechrest called “dignified ruthlessness,”⁵⁹ or what I would call courage.

While the (mistaken) ideas of political economists about how the mixed economy works (or doesn’t) are influential, ultimately political and moral philosophy is even more important. As Chaucer asks, if the gold rust, what will the iron do? Rusting gold is our plight, the ultimate source of our bad policies. Capitalism was destroyed despite delivering the goods and eradicating poverty like no other system in history, an incredible story. Why? “The answer lies in the fact that the lifeline feeding any social system is a culture’s dominant philosophy and that capitalism never had a philosophical base,” writes

⁵⁸ http://mises.org/journals/qjae/pdf/qjae4_3_6.pdf

⁵⁹ Larry J. Sechrest, “The Anti-Capitalists: Barbarians at the Gate,” <http://mises.org/daily/2921>

Ayn Rand. “No social system (and no human institution or activity of any kind) can survive without a moral base. On the basis of altruist morality, capitalism had to be—and was—damned from the start.”⁶⁰

⁶⁰ Binswanger, *op.cit.*, pp. 61-2.