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OUR

POST-CRASH ECONOMY

"I'm tired of seeing government spend money it doesn't have—

to fix problems created by people spending money they didn't have."

...Viewer of ABC News

Previous by Author:

THE U.S. DOLLAR AN OWNER'S MANUAL

SOCIAL SOVEREIGNTY

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Introduction

After the onset of the Great Recession, deregulation was widely and correctly identified as the source of the financial imbalances that culminated in the 2007 crises. To avoid misunderstanding regarding this statement it should be seen that effective regulation occurs from forces outside of the purview of government by the forces of competition and market based choices. Most of the regulation and governance of the economy stems not from the proactive legal and political institutions but from market enforced discipline. Regulatory ineffectiveness resulted from the legal environment erected in the name of certain of those institutions, both deliberately and unintentionally.

Layering of more regulatory legislation with the intention to prevent future economic excesses is the usual reaction to economic crises and distress. Some of the September 2008 policy actions have been defended as an emergency tool, such as the shoring up of the depository collapse that in 2007 might have culminated over only a few hours in a loss of trust in financial accounts and the freezing of the electronic payment system.

Allowing depository institutions to be legally protected from the consequences of lending the money that depositors expect to be held in trust produced a gaping chasm in liquidity. It was necessary to back up those deposits immediately or face the all too possible breakdown of the payment system along with a cascade of disruptions. But less understood is that given the gradual erosion of bank liquidity and decades of credit inflation, such monetary expansion created unstable conditions. Funds resulting from artificial leverage were not costless just because they could ultimately be backed by emergency FDIC-Treasury assurances. Infusion of money into an economy, is an equivalent loss to non-recipients, a tax on the public at large, with precisely the damage that a counterfeiting cabal would effect. The process has been responsible for reducing the dollar to less than a tenth of its value over the post WWII decades. The damage was already a fact before the crises.

Unfortunately the other policy fixes after 2007 resulted in unprecedented Trillion dollar financial flows propping up some of the culprits themselves, especially in those sectors that were erected on top of all of the phantom credit base.

Economic propositions, strictly speaking, relate cause and effect. They need not imply that any policy should or should not be instituted. One could demonstrate a clear benefit to the economic output by increasing one tax rate and reducing another without thereby making a judgment that it should be carried out. One may want to reduce the output of the economy; one may dislike people altogether and hope their economy collapses. But the economics would not be any different. Like geometry, for a given set of assumptions you get a given result.

In practice normative political views in discussions of the economic policies of the day are seldom avoided. The main theme in any textbook on macroeconomic theory revolves around application of theory to governing the economy by overriding the market through implying macroeconomic policy for specific normative outcomes such as increasing employment.

However, the economics of a policy action is invariant to interpretations of the advisability of its implementation. The economics must be logically consistent nevertheless, just as a proof in geometry is or is not correct.

Others have taken the road of engaging and participating in government to accomplish social ends. It is hoped that the tone of this book is not taken to detract from these laudable efforts by fellow travelers, or to conclude any intolerance to their own interpretations of events different from those cited here.

While others looked for the source of social problems in corporatist power and hoped to use state power to interpose corrective measures, there exists the alternate view that first one had to prevent unnecessarily instituting state (coercive) power to avoid attracting capture by private interests; and that, contrary to established opinion, compulsory government was not the best means of collective or social cooperative action.

Another way of describing free markets is freedom to make exchanges with other people. Here the fact that no exchange takes place without ex-ante perceived benefit to both parties implies a system that results in a larger pie, not just a way of dividing the pie.

Authoritative regimes tend to foreclose on the ability to employ that great leveling force of competition. It can be demonstrated that ordinary people can associate in innovative ways effectively and efficiently through the market to supply their needs. Examples of unplanned emergent order abound, from common law, to the development of mathematics, to the rules of golf, to insurance. These resemble the results usually attributed to government, but which upon examination need not be. Such social (in contrast to political) organizing emerges under freedom of choice. But benefits are not seen at first glance, it is mentally easier to visualize that a new legislated or decreed law will do the needed work.

In our look at the economy the economic ideas of less well-known perspectives including Marxist, Georgist and Austrian will be employed to assist explication.

In brief, Marxism never broke out of the pre-marginalist classical economics that explained price by classes of commodities and saw the source of value to be productive effort (ultimately labor) instead of desires of the user or consumer.

And Georgism, in maintaining that just title to land (and natural resources) should reside in the whole of mankind, was in favor of taxing exclusively land and nothing else (hence the single tax), while for expediency, allowing titles to remain in their present hands, with structural improvements such as houses and buildings to be free of taxation.

However, taxing the entire imputed rent from land, which was the Georgist ultimate reduced-state position, while viable may neglect beneficial allocation and coordination provided by entrepreneurs, possessing foresight of changing land values in a changing world with uncertainty. Georgists widely opposed market intervention by the state elsewhere for good reason, yet championed empowering the state with an absolute public claim on resources and land.

Even so, some writers applied Georgist oriented ideas to revenue neutral tax reform without moving closer to or further from the free market. They assigned a leading role to land value cycles in the business cycle with valuable insights as to why.

In balance, Austrians supplied more developed answers to shortcomings of classroom neoclassical theory. Good ideas were too often overlooked, or were in need of repeating, both the Georgists and Austrians applied methodological individualism. Geo-Austrians synthesized both.

To be clear, Austrian methodological individualism translates to a micro rather than macro approach to economics, but does not deny the cautious use of aggregates and averages in analyzing macroeconomic phenomena; nor does it deny the reality of public or collective interests and actions when carefully defined as individually based.

Here remains the essence of the debate over financial regulation in the aftermath of the Great Recession of 2008.

Our inquiry draws chiefly on the economics of Böhm-Bawerk, Mises, Hayek and Rothbard, which comprise the core of Austrian economic theory. We will highlight some of these, along with others, to shed light on our economic future.

While it is not possible to forecast timing for economic events, it is possible to eliminate some unlikely outcomes, and to elevate others through consistent application of causal logic.

Conventional following in economics saw a need for a central bank and government management of the economy to moderate fluctuations in economic activity. We can now examine this proposition by considering the free-market and free-banking perspective.

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In 1913 Congress established the Federal Reserve System (Fed). As a central bank it was purported to moderate what seemed to be naturally occurring financial crises. But now the evidence is in: prior to the centralization of the control of money and banking by government intervention these occurrences were not prolonged or as severe as after 1913. Under the Federal Reserve we have experienced a Great Depression, suffered the stagflation of the 1970's, a recession in the early Eighties, and now a financial panic and Great Recession beginning in 2007.[1]

Some critics of the Fed have proposed turning over the power to expand the money supply to the Treasury, out of the hands of the Fed. While thereby limiting control by the Fed (a quasi-private institution) we will see that this is no substitute for a true market disciplined monetary system based on free banking and dollar convertibility.[2]

In considering capital and monetary policy stimulus in the post-crash economy we can surmise that the reason that the Fed can't rescue a collapse by inflating liquidity is that this money would go to short term investments. This could produce a steep positive yield curve (short rates lower than long rates).

Market sentiment is different once the boom has collapsed. The economy tends to seek short term liquidity and avoids investing in long horizon projects.

Unlike a credit stimulated boom, inflation in short duration investments and deflation in longer-term investments occurs. Investing in longer term instruments of a financial nature may not be investment in

[1]Federal Reserve Chairman Ben Bernanke attempted to make a case blaming foreign savings for contributing to the recent equity and real estate bubbles in the U.S., but, economists (e.g. George Reisman) have demonstrated, not only were these sources of funds insignificant when compared to bank credit expansion from the mid 90's on, they aren't transitory in their effect as is artificial credit.

[2] (Mises [1912] 1971 and Mises 1966) Mises's treatise on money was used as an economics text on the Continent. Mises, in 1922 was called on by the Austrian chancellor for his expertise in monetary policy to successfully remedy what remains a historically defining period of inflationary crises in Europe.

capital or business ventures. Hence it may fail to help employment that could be aided in a faster turnover of capital; the effect is similar to the Keynesian liquidity trap early in a correction.

Quantitative easing, without more saving and improved business outlook, is like pushing on a string. So in 2008 the attempt at stimulus was ineffective. Note that by 2015 long term rates were coming down as the stimulus took effect in longer duration investments.

Eventually the effect of lower interest rates and easing for longer-term capital has its effect. The 2014-15 slide in oil prices reflected longer duration investment in capital intensive projects in oil infrastructure having been overstimulated by low interest rates in preceding years stimulating over-production of oil.

But this blunt, massive provision of investible liquidity and credit in the capital markets from quantitative easing inhibited recovery in other sectors by redirecting resources into investments not chosen by market signals.

When the economy is most slack in labor usage, capital would be more remunerative in types of enterprise that takes advantage of this slack. For example in the labor intensive cultivation of berries—requiring financing to hire labor with little financing for fixed or durable physical capital. In contrast is the cultivation of barley, on identically fertile plots of land, in the same region, that uses little labor but large-scale machinery (Mason Gaffney 2009).

Where both would generate similar profit rates, the former uses a much higher mix of labor with physical capital, but with both using the same amount of funds.

In this example, directing funds to sustain the less labor intensive enterprises that were predominant before the crash directs land usage and funds away from the techniques of production that relieves unemployment and towards those that tie up funds in long-term capital equipment. The policy of replacing older autos, requiring more labor using maintenance than new replacements, was exactly the wrong policy for reducing unemployment.

Can any central planning committee do, by what Hayek calls the fatal conceit, what the market can do by the miracle of price signals? Do we even know where these policies have gone wrong other than that unemployment and economic malaise have been inordinately prolonged?

It has been thought that if the end of a period of lowered interest rates caused the cessation of expansion and boom then logic would argue in favor of reinstituting low rates to correct the recession. The reason that a low interest rate cannot return us to the boom of the expansion is that the expansion was a period of ongoing ever-worsening alignment of complementary productive processes, elevated measures of misdirected employment, GDP notwithstanding.

Austrians have emphasized the folly in thinking of the economy as either enjoying more or less economic activity. Their more sophisticated chain of reasoning complies with common sense. We can consume capital on the one hand and invest in the wrong capital projects on the other. Each of these may elevate measures of current GDP; but each of these subtracts from the ability to deliver supplies of usable goods and services in the future.

The correction not only must re-value these misappropriations, but it must liquidate them at a loss and terminate whole enterprises the most out of line with balanced production. The workforce must be relocated and retrained.

A community could begin a project to build a tunnel to access what requires a difficult journey over a mountain. It could employ plenty of engineers, train workers in demolition and excavation, and invest in

heavy equipment. But if halfway through the mountain the community runs out of the means to support its workers, then when they go back to their original activities they have nothing to show for their work and are worse off from having depleted their resources. Yet, while engaged in the project they were experiencing a boom in employment and economic activity. Their economists said they were on the right track because they enjoyed a high level of aggregate demand, but they were misled as to their provisions because the authorities dispersed provisions at a rate that would deplete the granaries faster than they could be supplied. The Austrian Business Cycle Theory contains similar insights regarding easy credit upswings in the economy.[3]

[3] "It is true this theory suffers from a serious disadvantage: it is so much more complicated than the traditional monetary explanation. But I venture to say that this is not the fault of this theory, but due to the malice of the object."(Gottfried Haberler, 1932, 64).

Part I

Our Economy

METHODOLOGY

Strong statistical correlations between facts and outcomes have been misinterpreted. The population of people who spend more has a high correlation coefficient with those who are wealthy. But we know that one does not become wealthy by simply increasing his/her spending. Yet precisely this reasoning is employed by economists who subscribe to the consumptionist fallacy that finds the cause for prosperity in consumption. Here economic logic is needed to sort things out. We will see how understanding that the transaction between buyer and seller of final goods while 70% of final aggregate output, is only perhaps 40% of total economic activity. A structural model of the economy allows for such a deduction. It reveals that diverting spending from consumption to investment spending aids in the growth of output over time, a logical outcome.

Of course in mere logic there is treachery. There are an abundance of superficial causes proposed to explain movements in variables such as GDP, credit conditions, standards of living etc.

Indeed, we may have more to go on than in the physical sciences that only have inanimate objects and data to observe. We know that people act employing means to achieve ends. Fruitful analysis starts with knowledge about real individual people, their subjective assessments, motivations, quirks, etc. True, we acquire behavioral understanding about market participants inductively; we employ certain self-evident attributes arrived at by our life experience. But the analysis goes from (known) cause to effect.[4]

Applying insights deductively, for example, leads us to derive general propositions about money as a means to relieving human needs.[5] As we will see, dramatic changes in subjective preferences for money (demand for money), usually initiated by policy actions controlling trends in money supply growth, may

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[4] This causal realist methodology has been well defined by Ludwig von Mises (1949), and (1957).

[5] Note that we are not talking about strictly material needs, or *homo economicus* "economic" man, but man who has the capacity to choose even non-material or non-market valued ends.

cause such dramatic events as a boom ending in hyperinflation or a bust ending in hyper-contraction or deflation.

Our approach avoids sterile equations or equilibrium assumptions that too easily ignore the human element in our most basic unit of analysis. We are aware that economic participants never enjoy certainty of knowledge, and that there are therefore uneven and unpredictable periods of adjustment. At the same time we see that the free market out performs centralized command systems, even though absent perfect competition or perfect knowledge. Lack of these artificial constructs or hypothetical conditions of perfect competition or perfect knowledge in no way diminishes the viability of the free market process. Markets can be perfectly rivalrous without meeting the artificial criteria of perfect competition, hence, contrary to received doctrine, absence of a multitude of competitors in a market is no indicator of market failure.

Economics has been characterized as the *dismal science*. We might all agree to this characterization, not because of the famous but only narrowly applicable Malthusian fear of population pressure keeping the masses at subsistence, rather because reality makes us face the need for work, to seek information, understand markets, exchange etc. to gain what we don't have. Economics makes use of the fact of scarcity. Economics is about scarcity.

Economics is a discipline that begins with human actions and interactions; physical sciences study inanimate objects. Attention to what is already known in a science of acting groups and individuals allows economists a head start compared to physical scientists. Inquiry starts with the unknown when it comes to the behavior of units of action such as atoms or molecules. In the physical sciences the laws of behavior must be discovered by experimentation and observation of regularities. But in economic science we know that behavior is purposeful in actions undertaken by people. This allows for starting analysis not at the rudimentary physical level of the world of inanimate objects but at a human level, a social level. Baseball can be understood much sooner if we already have insight to the rules of the game, than if we start out trying to discover the rules only by observing regularities in behavior. In economics, unlike the physical sciences, we can arrive at useful precepts more readily through deductive rather than by inductive investigation.

Models need to be internally consistent logically, with realistic assumptions. As in geometry, axioms lead deductively to contextually useful propositions. A good theory may only apply to one period or set of events, it may be relevant in one case and not another. But we should not expect to arrive at a theory from looking at or testing against the data available.

MONEY INFLATION

Under conditions of monetary inflation, the newly injected money flows in a systematically uneven manner through the economy. The first recipients of spending, limited in number, face uninflated prices. The majority of people experience little initial effect from the spending stimulus only to later face prices bid up to their disadvantage. Think of counterfeiters spending new money. Each of the rest of us loses just a little as they gain what we lose. We will see below how credit expansion distorts business growth from a sectoral standpoint.