FREEMarket

PUBLISHED 12 TIMES PER YEAR BY THE LUDWIG VON MISES INSTITUTE

A Microcosm of Boom-Bust

George Reisman

George Reisman is Pepperdine University Professor Emeritus of Economics and the author of Capitalism: A Treatise on Economics (Ottawa, Illinois: Jameson Books, 1996) (georgereisman@georgereisman.com).

he essential features of the boom-bust business cycle can be understood by viewing them in terms of the financial circumstances of a single individual. Thus, imagine that an ordinary person has been going about his life more or less living within his means. And now, one day, he receives a registered letter from a major bank. The letter informs him that he is the sole heir of a distant relative who possessed a substantial fortune, and that he should come into the bank's main office in his city to sign the necessary documents and receive all the necessary authorizations to henceforth dispose of this fortune as he sees fit. Naturally, he quickly goes in and takes possession of his newfound fortune.

Whether the fortune in question is \$100 million or \$10 million, it is certain to have a major impact on this individual's life from this point forward. For it opens up new worlds to him by enabling him to now afford to buy things he could never dream of buying before. He can now afford a new home, perhaps a mansion. He can buy a whole new wardrobe, travel the world, quit any job that he currently has and does not love.

If he is in business, he can expand his business in major ways. If he is not in business, he can start a significant-sized business. And he can now afford to invest and speculate in the stock and real-estate markets as well, inasmuch as his newfound wealth makes it possible for him no longer to fear losses of mere hundreds or thousands of dollars; indeed, it appears that he can now afford to lose even a million dollars and still be very rich.

This is the boom period for our individual. His life is easy. He can do so much more than he had ever been able to do before. And his prospects appear limitless. For the rest of his life, he will look back upon this period with the greatest fondness and ardently wish to relive it. It is "the good times."

The Bust

What puts an end to our individual's life of ease is a second letter. This letter explains that it has now been proven that the relative whose fortune he's received had obtained it by criminal means. Thus the fortune did not in fact belong to

2 December 2010 The Free Market

that relative and therefore could not properly be passed on by him to anyone else.

As a result, the bank concludes, our individual is obliged to return the fortune. Accordingly, all of his accounts with the bank in question have been frozen and court orders have been obtained prohibiting him from spending any more of what he has thought of as his inheritance and demanding the return of whatever is left.

Our individual now finds himself buried in a mountain of debt that he cannot repay. He must sell his home or mansion, most likely for less than he had paid for it. (If for no other reason, this will likely be the case simply because of the payment of brokerage fees and the inability to wait very long for the right buyer.) Selling the clothes and many of the other goods he had bought will likely yield only pennies on the dollar. All that he had spent in traveling the world will be a total loss, as will be his expenditures on many other forms of luxury consumption.

As for his investments, they may be profitable or unprofitable. However, given our individual's lack of great financial success prior to his receipt of his inheritance, it is more likely than not that they will have been unprofitable.

The upshot of all this is that our individual's receipt of his "inheritance" has turned out to be a financial catastrophe for him. By leading him to make massive purchases in the mistaken conviction that he owned a fortune, when in fact he did not, it has led him to live far beyond his means and

to squander much or all of the wealth he had prior to his coming into his "inheritance."

Boom-Bust in the Wider Economy

The pattern of boom-bust in the wider economy is essentially similar to what has been portrayed in the case of this individual. In both cases, the boom is characterized by the appearance of great new and additional wealth that does not in fact exist. The bust is the aftermath of the economic behavior inspired by this illusory wealth.

In the boom-bust cycle of the wider economy, the illusory wealth does not take the form of false inheritances but of newly created paper bank credit that is confused with capital representing real, physical wealth. At the instigation and with the support of the Federal Reserve, in the most recent boom banks created several trillion dollars of new and additional money, which they lent out. On the foundation of this fictitious capital, the economic system was led to proceed as though corresponding new and additional physical wealth had come into being. The result, among other things, was the construction of perhaps as many as three million new houses for which people could not pay.

In reality, the capital actually available in the boom is insufficient to support the projects that are undertaken on the foundation of the credit expansion. Instead of creating new and additional capital, credit expansion serves to drive up wage rates and the prices of capital goods. This reduces the

Copyright © 2010 by the Ludwig von Mises Institute, Creative Commons 3.0. ISSN: 1051-4333.

Editor: Jeffrey A. Tucker

Contributing editors: Thomas J. DiLorenzo, Jeffrey M. Herbener, Robert Higgs, Mark Thornton

Publisher: Douglas E. French

The Free Market is published 12 times a year.

Note: the views expressed in the Free Market are not necessarily those of the Ludwig von Mises Institute.

Ludwig von Mises Institute, 518 West Magnolia Avenue, Auburn, Alabama 36832-4501 Phone: 334.321.2100; Fax: 334.321.2119; Email: info@mises.org; Web: mises.org

The Free Market December 2010 3

buying power of capital funds. Ultimately, it creates a situation in which those who normally would have been in a position to lend money find that they cannot lend, or cannot lend as much, because they need the funds to finance their own internal operations that now must be carried on at higher wage rates and prices of capital goods. At the same time, for the same reason, borrowers find that the funds they have borrowed are insufficient. Thus borrowers need more money while lenders can only lend less. The upshot is a "credit crunch," in which firms go bankrupt for lack of funds.

In the boom phase, massive debts have been accumulated. As these debts become unpayable, the capital of the firms that have lent the funds is correspondingly reduced. In the process, the capital of the banks that have created the new and additional credit can be wiped out, creating the potential for bank runs and an actual decline in the quantity of money in the economic system. The mere specter of such events creates a major increase in the demand for money for cash holding, with the result that spending in the economic system starts to decrease even without an actual fall in the quantity of money.

The conclusion to be drawn is that the key to avoiding "busts" is to avoid the credit expansion and "booms" that cause them. Booms are not periods of prosperity but of the squandering of wealth. The longer they last, the worse is the devastation that follows.

The Gold Standard Lives

Llewellyn H. Rockwell, Jr.

Llewellyn H. Rockwell, Jr., is founder and chairman of the Ludwig von Mises Institute and editor of LewRockwell.com (Rockwell@mises.com).

ohn Maynard Keynes thought he had pretty well killed gold as a monetary standard back in the 1930s. Governments of the world did their best to help him. It took longer than they thought. Gold in the money survived all the way to Nixon, and it was he who finally drove the stake in once and for all. That was supposed to be the end of it, and the beginning of the glorious new age of paper prosperity.

It didn't work out as they thought. The 1970s was a time of monetary chaos. What was worth a buck in 1973 is worth only 20 cents today. Stated another way: a dime is worth 2 cents, a nickel is worth a penny, and a penny is worth . . . nothing at all. It is an

accounting fiction that takes up physical space for no reason.

Welcome to the age of paper money, where governments and central banks can manufacture as much money as they want without limit. Gold was the last limit. Its banishment as a standard unleashed the inflation monster and leviathan itself, which has swelled beyond comprehension.

But guess what? Gold actually hasn't gone anywhere. It is still the hedge of choice, the thing that every investor embraces in time of trouble. It remains the most liquid, most stable, most fungible, most marketable, and most reliable store of wealth on the planet. It has a more dependable buy-sell spread

4 December 2010 The Free Market

than any other commodity in existence, given its value per unit of weight.

But is it dead as a monetary tool? Maybe not. Whenever the failures of paper become more-than-obvious, someone mentions gold and then look out for the hysteria. This is precisely what happened the other day when Robert Zoellick, head of the World Bank, made some vague noises in the direction of gold. He merely suggested that its price might be used as a metric for evaluating the quality of monetary policy.

What happened? The roof fell in. Brad DeLong of Keynesian fame called Zoellick "the stupidest man alive" and the *New York Times* trotted out a legion of experts to assure us that the gold standard would not fix things, would hamstring monetary policy, would bring more instability rather than less, would bring back the great depression, and lead to mass human suffering of all sorts.

One thing this little explosion proved: newspapers, governments, and their favored academic economists all hate the gold standard. I can understand this. The absence of the gold standard has made possible the paper world they all love, one ruled by the state and its managers, a world of huge debt and endless opportunities for mischief to be made from the top down.

One of the funniest explosions came from Nouriel Roubini, who listed a series of merits of gold without recognizing them as such: gold limits the flexibility and range of actions of central banks (check!); under gold, a central bank can't "stimulate growth and manage price stability" (check!); under gold, central banks can't provide lender of last resort support (check!); under gold, banks go belly-up rather than get bailed out (check!).

His only truly negative point was that under gold, we get more business cycles, but here he is completely wrong, as a quick look at the data demonstrates. And how can anyone say such a thing in the immediate wake of one of history's biggest bubbles and its explosion, which brought the world to the brink of calamity (and it still isn't over)? Newsflash: it wasn't the gold standard that gave us this disaster.

As Murray Rothbard emphasized, the essence of the gold standard is that it puts power in the hands of the people. They are no longer dependent on the whims of central bankers, treasury officials, and high rollers in money centers. Money becomes not merely an accounting device but a real form of property like any other. It is secure, portable, universally valued, rather than falling in value, it maintains or rises in value over time. Under a real gold standard, there is no need for a central bank, and banks themselves become like any other business, not some gigantic socialistic operation sustained by trillions in public money.

Imagine holding money and watching it grow rather than shrink in its purchasing power in terms of goods and services. That's what life is like under gold. Savers are rewarded rather than punished. No one uses the monetary system to rob anyone else. The government can only spend what it has and no more. Trade across borders is not thrown into constant upheaval because of a change in currency valuations.

Of course the World Bank head was not actually talking about a real gold standard. At most he was talking about some kind of rule to rein in central banks that attempt what the Fed is attempting now: inflating the money supply to drive down the exchangerate value of the currency to subsidize exports.

Still, it's good that he raised the topic. The Mises Institute has been pushing scholarship and writing about gold since its founding. To be sure, the issue of the gold standard is largely

The Free Market December 2010 5

historical, but no less important for that reason. The people who hate the gold standard of the past have no desire for serious monetary reform today.

We should be thrilled should the day ever come when monetary authorities really make paper money directly convertible into gold (or silver or something else). I doubt we can look forward to that day anytime soon. But one thing they could let happen right away: free the market to create its own gold standard by permitting true innovation and choice in currency. It's a fair guess that opponents of the gold standard would oppose that too, because, as Alan Greenspan himself once admitted, the people who oppose gold are ultimately opposed to human freedom.

This debate isn't really about monetary policy, much less the technical aspects of the transition. It is about political philosophy: what kind of society do we want to live in? One ruled by an ever-growing, all-controlling state or one in which people have freedom guaranteed and protected?

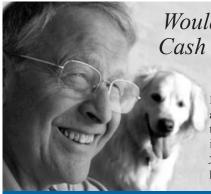


Naples, Florida

,, Saturday, February 26, 2011



For more information see Mises.org/Events.



Would You Like to Increase Your Cash Gifts to the Mises Institute?

Will you need all of your IRA during life?

If you are over age 70½, you can make an "over and above" charitable gift from your IRA up to \$100,000 this year. Since this IRA rollover is not included in your income, the gift will be *tax-free and have no impact on your regular charitable gifts*. For more information, please contact www.SupportMises.com

For more information contact James W. Fogal, CFP, ChFC • 800.861.7426 • James@Mises.com

6 December 2010 The Free Market

In Memoriam

This year, the Institute lost some wonderful supporters:

We mourn the passing of **Roger Milliken**, 95, of Spartanburg, South Carolina, Charter Member and great benefactor of the Institute. A hugely successful textile entrepreneur and conservative stalwart of the Republican party, he also ran annual anarchist seminars for his executives, taught by the late Robert LeFevre, whose papers and library grace the Institute.

Mrs. Esther E. (Pat) Andrews of Los Angeles, California. She was a pilot, a cartoonist for the *LA Times*, and an avid sailor with her late husband Jim Andrews—also a great supporter—who was Commodore of the Santa Monica Yacht Club.

Mrs. Maxine "Mickey" Young of Allison Park, Pennsylvania. A 1941 graduate of the University of Pennsylvania Graduate Hospital, she worked as a medical technician until 1950 when she became a full-time homemaker and mother. She was married for more than 65 years to Leland L. Young, and together they were Charter Members of the Mises Institute.

Mr. Richard E. Tenney of Bainbridge Island, Washington. A great athlete in his youth, he pitched softball until the age of 86. Dick was a graduate of the Naval Academy, and an engineer for GE and Kaiser Aluminum.

Carol R. Archer, M.D., of St. Louis, a former professor of radiology and neurology at Saint Louis University.

Mr. Charles Scott Hamel of Chapin, South Carolina. A Latin teacher, he was the founder of the Foundation for American Education, which brought back into print such important books as *Lincoln the Man* by Edgar Lee Masters, and the publisher of *Southern Partisan Magazine*.

Mr. Joseph Sobran of Burke, Virginia. He was former senior editor of *National Review Magazine*, a CBS commentator, a syndicated columnist, and the author of three books. A conservative turned libertarian, his writing has been compared, with justice, to H.L. Mencken's.

Dr. James E. Foy of Auburn, Alabama. A former dean of students at Auburn University, he was a graduate of the University of Alabama and Michigan State University, a fighter pilot in WWII, and a competitive skier into his late 80s. Like his late wife of 60 years, Emma Lu, he loved the Mises University.

Mr. Manuel Ayau was the principle founder of the Universidad Francisco Marroquin in Guatemala. He was also a successful entrepreneur, and a dedicated teacher of Austrian economics.

Mrs. Deborah B. Printz of Stone Mountain, Georgia. Mr. Richard L. Fortner of Burlington, Iowa, a Charter Member of the Institute. Mr. Clement P. Hill of East Rockaway, New York, a Member for 25 years. Mr. Stanley Porter of Los Alamitos, California, Member for 23 years. Mr. David L. McDuffie of Orlando, Florida, Member for 23 years. Mr. J. Mark Montgomery of Arlington, Virginia, Member for 22 years. Mr. John McCluskey of West Coxsackie, New York, Member for 22 years, and Mr. Robert W. Kerney of Cotati, California, Member for 21 years.

Mr. Fred Childress of Oak Ridge, Tennessee. Mr. J. Patrick Bedell of Hollister, California. Mr. Frank B. Diamond of Merion Station, Pennsylvania. Mr. William J. Hammond of San Antonio, Texas. Ms. Sarah Hesselgesser of Centerville, Ohio. Mr. Jesse C. Holmes of Kingwood, Texas. Mr. Malcolm Klein of State College, Pennsylvania. Mr. H.G. Osborn of Ward, Arkansas. Mr. Charles E. Person of Vestavia, Alabama. Mr. H.R. Roman of Ramsey, New Jersey. Mr. Ronald Sinclair of Gambrills, Maryland. Mr. Joseph J. Triolo of Narbeth, Pennsylvania. Ms. Marlene Vasconcelos of Los Angeles, California.

May their great souls rest in peace. At the Mises Institute, we will honor their memory by working as hard as we can for the ideals of freedom they cherished.

The Free Market December 2010 7



Register for any conference online at mises.org or by phone at 800.636.4737.

- HIGH-SCHOOL SEMINAR IN KNOXVILLE, TENNESSEE AREA February 11
 Sponsored by Tennessee Liberty Alliance
- THE MISES CIRCLE IN NAPLES, FLORIDA
 February 26 Naples Beach Hotel Sponsored by an anonymous donor,
 Avery Knapp, and Stephen & Monica Hillis
- AUSTRIAN SCHOLARS CONFERENCE March 10–12
 Mises Institute
- HIGH-SCHOOL SEMINAR IN CHICAGO April 8 • Sponsored by Jeremy S. Davis
- THE MISES CIRCLE IN CHICAGO
 April 9 Chicago, Illinois Sponsored by Dr. Don Stacy
- HIGH-SCHOOL SEMINAR IN AUBURN April 29
 Mises Institute
- HIGH-SCHOOL SEMINAR IN AUBURN June 10
 Mises Institute
- ROTHBARD GRADUATE SEMINAR June 12–17 • Mises Institute
- THE MISES CIRCLE IN LAS VEGAS July 14–16
- MISES UNIVERSITY
 July 24–30 Mises Institute
- ANNUAL SUPPORTERS SUMMIT AND SCHLARBAUM AWARD September 19–23
 Vienna, Austria
- THE MISES CIRCLE IN NEW ORLEANS November 5 • New Orleans, Louisiana
- HIGH-SCHOOL SEMINAR IN AUBURN November 18 • Mises Institute

The FREEMarket

Ludwig von Mises Institute 518 West Magnolia Avenue Auburn, Alabama 36832-4501 Join us February 26 in Naples, Florida!

See inside for details!

Nonprofit Org. U.S. Postage PAID

Ludwig von Mises Institute