

The

# FREEMarket

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## KEYNES'S UPSIDE-DOWN WORLD

Mark Thornton

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John Maynard Keynes often employed flowery language like “animal spirits” and “liquidity trap” to describe things he did not understand. He was, after all, more of a bureaucrat than an economist. In fact, he would best be described as an anti-economist because he eschewed things like supply and demand and held the opinion that government could run the economy.

So, for example, he could not understand why people would invest resources in risky adventures that helped keep the economy growing at full employment. He therefore substituted “animal spirits” for the profit motive. These spirits allow entrepreneurs to proceed with a naïve confidence and to set aside concerns over losses.

Similarly, the failure to invest was also a psychological problem that he dubbed the “liquidity trap.” This trap occurs when investors seek liquidity in cash and when monetary policy—in terms of cutting interest rates—no longer produces an increase in investment.

The problem with Keynes is that he thought that if entrepreneurs lose their collective nerve, the government should socialize investment, prop up demand and employment, and provide assurances to drive the economy back to full employment. He did not understand how the economy works, so he could not understand how the economy corrects itself once a contraction occurs.

The problem for us is that Bush, Obama, Geithner, and Summers are all following the Keynesian playbook, with Nobel laureate Paul Krugman serving as head cheerleader. If instead we just allowed the free-market process to work, the economy by now would likely have already bottomed; companies like AIG would be emerging from bankruptcy and the unemployment rate would be dropping instead of continuing to rise.

The market process was curtailed just a few months into this contraction and—over the last 15 months—has been almost wholly replaced with government intervention. Many of the interventions have been rightly described as “unprecedented” in that they are completely untried. This means that neither market participants nor policy makers have experience with them—and it shows.

This slew of interventions has been disorderly. Many interventions, like the takeover of AIG, were total surprises, causing volatility in stock markets. Moreover, these →



interventions have been extremely large and wide-ranging in scope. Measured in dollar terms, the money “allocated” totals over \$12 trillion by one account.

Ironically, by adopting the Keynesian position that we have lost our “animal spirits” and are suffering from a psychological problem of fear, the government has undertaken extreme policy changes that greatly undermine the profit motive. Entrepreneurs are no longer looking for new profit opportunities in the economy. Instead, they are more likely to either be trying to preserve their capital or lining up for a government bailout. The pathetic statistics on domestic investment bear this out.

Preservation of capital requires that you place your wealth in low-risk assets like government bonds, cash, CDs, and gold. So people are saving more and paying down debt to protect themselves, but in Keynesian terminology, we have fallen into the very dangerous liquidity trap.

For Keynes, the liquidity trap occurred when frightened consumers attempted to save more and consume less. He reasoned that less consumption would hurt businesses and production and therefore put businesses and labor at risk. These lower incomes would mean, in turn, that the attempt to save more would actually result in a much worse economy.

The liquidity trap is really about hoarding and saving. While hoarding has a bad name among some economists, it actually is a very good thing. Typically, people do not hoard resources irrationally or for no reason; they hoard as a way to protect themselves from dangerous situations.

Depression, inflation, war, and other calamities are typically what cause people to hoard.

Not only does the increased saving help the economy, but hoarding is actually a good thing because it helps facilitate the process of deflation and deflation helps bring about recovery. If people reduce consumption (demand) then prices fall, particularly in the early stages of production.

As all types of resources and goods are becoming cheaper, including labor, the purchasing power of every hoarded dollar increases. All the prices that were bid up during the boom—particularly land, capital, and various asset classes—are thus reset at lower levels. Debt is liquidated and savings are restored and the prospects for a return to prosperity emerge, first among producers and then by consumers. Therefore hoarding speeds up deflation and deflation speeds up the correction process.

But Keynesians are afraid of this process because they don’t understand how it leads us back to full employment and economic growth. I have named this fear apolithorismophobia. Joseph Salerno has shown that there is no theoretical basis for this fear and Greg Kaza has shown that there is no empirical basis for this fear.

Ironically, it is Keynesian policies, such as bailouts, stimulus packages, and inflation that should be feared, because they can threaten our animal spirits for profit and leave us stuck in the liquidity trap for many years.

Hoarding eventually fixes most balance sheets, but in a Keynesian-dominated economy, it takes an extremely long time. During the interval, people can become permanently jaded about the market and investing. They may become permanent hoarders. This is what happened to many

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Americans who lived through the Great Depression. Frugality and thrift, while admirable, became a kind of psychological scar they wore for the rest of their life.

Keynesian-style policies have resulted in disasters such as the Great Depression, the “stagflation” in the United States from 1970 to 1982, and the aftermath of the Japanese Bubble. Each lasted more than a decade. It would be far better to allow for an unobstructed free-market correction process. With no government safety net or bailouts, there would be more hoarding, faster deflation, more bankruptcy, and a speedy return to prosperity.

While bankruptcy sounds horrible, it is actually a wonderful and orderly process. First of all, it fixes balance sheets quickly. It also provides an opportunity to remove current owners and administrators who operated businesses in a risky fashion. No need to worry about bonus questions here! Some bankrupt firms will go completely out of business and their resources will be auctioned off to other entrepreneurs at very low prices.

I would imagine that the dozens of startup firms working to bring electric cars to market would love the opportunity to buy an auto plant in Michigan

for pennies on the dollar. Other firms will remain in business with most workers keeping their jobs, but bankruptcy reduces debt and cost and provides an opportunity to renegotiate contracts and wage rates.

The resulting environment after bankruptcy is one of new owners and operators with far less debt who have not had their “animal spirits” crushed. Firms would have less debt and therefore lower cost structures. Some consumers would be flush with hoarded cash and have an opportunity to buy at much lower prices. The economy enters recovery mode and can quickly attain full employment and economic growth.

Most importantly, by not bailing out the losers, there is no moral hazard that entrepreneurs will believe they can rely on bailouts in the future.

Because they do not understand how the market works, Keynesians think this is a fantasy. But if you follow the Austrian recipe of allowing liquidation of bankrupt firms and debt, allowing prices to fall without monetary inflation, not propping up employment or subsidizing unemployment, and not discouraging hoarding, you will end up with the quickest possible recovery and minimize the magnitude of economic pain. ■



## Mises Institute EVENTS

Register for any conference online at [mises.org](http://mises.org) or by phone at 800-636-4737.

- REMEMBERING BURT BLUMERT: A MEMORIAL  
July 25, 2009 • Auburn, Alabama
- MISES UNIVERSITY  
July 26–August 1, 2009 • Auburn, Alabama
- SUPPORTERS SUMMIT  
October 21–24, 2009 • Salamanca, Spain
- THE MISES CIRCLE IN NEWPORT BEACH  
(Sponsored by Louis E. Carabini)  
November 14, 2009 • Newport Beach, California
- THE MISES CIRCLE IN HOUSTON  
(Sponsored by Jeremy S. Davis)  
January 23, 2010 • Hilton Post Oak
- AUSTRIAN SCHOLARS CONFERENCE  
March 11–13, 2010 • Auburn, Alabama

# CONSCRIPTION OF MEN, WOMEN, AND RESOURCES

Art Carden

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Should we be conscripting people into the military or community service programs of some sort? Whether the government should require “national service” is a perennial issue that has enjoyed renewed emphasis during this time of economic strife, but let’s not mince words. What is compulsory national service but a type of slavery?

We can sing the praises of the ennobling and embiggening effects of time in the military or time in the peace corps, but this loses its luster when the ennobling and embiggening are done at the point of a gun. “Service” extracted at the point of a gun is not honorable. It is tragic.

Furthermore, conscription is a back-door way of increasing the state’s burden on society in a way that is more difficult to measure than taxing and spending. The use of compulsion suggests *ipso facto* that resources are being wasted.

Some may argue that this is an exercise in incendiary rhetoric, but it is also correct: compulsory service is slavery by definition. Call a spade a spade. Milton Friedman did when he referred to the conscripted army that was fighting in Vietnam as an army of slaves. They were. They went to Vietnam as a result of threats against life and limb. Some who took a principled stand against the war and in line with their convictions, like Muhammad Ali, were stripped of some of the most productive years of their lives.

Even if we grant the standard arguments in favor of national defense and in favor of a draft—e.g., national defense is a public good that will be underprovided by the private marketplace; it is unfair

that the children of the poor should find it disproportionately attractive to fight in order to defend the property of the rich, etc.—it is unlikely that the political process can improve on the market (or its close substitutes).

If public officials are to presume themselves responsible stewards of the resources with which they have been entrusted, this demands a thorough accounting for the epistemological problems associated with conscripted resources versus voluntary exchange. Robert Higgs offers a wide-ranging criticism of the military draft in his classic *Crisis and Leviathan*. This generates real insight into the problems of national service and conscription.

Higgs points out that people were slow to volunteer after the United States entered the war (p. 131). In spite of Woodrow Wilson’s stated opposition to conscription, he moved forward with a draft law that had been sent to Congress “the day before the declaration of war.”

Conscription carries with it the abrogation of all that is free about a free society. Ramped-up patriotic rhetoric attempted to convince the public that the draft was legitimate, and the government persecuted participants in anticonscription movements. The government drafted over 2.8 million men during 1917 and 1918, and Higgs speculates that many volunteers joined because they would have been assigned to worse duty had they been drafted. Predictably, the draft was subject to political gamesmanship, corruption, and favoritism among local draft boards.

# News from the Institute

## The Mises Institute Message

The pace of speaking activity has taken a dramatic upturn, as our scholars, staff, and adjunct fellows crisscross the country (even the globe) in order to counter the ridiculous propaganda coming out of Washington. The message is the same: it is intervention that created the meltdown and it is intervention that is prolonging it. Only the restoration of a free market will bring about the necessary liquidation so that prosperity can be rebuilt.

The Austrian economists are gaining more attention than ever before, and with our ranks now filled with professors, journalists, bloggers, and activists of all sorts, the message is being heard and it is making a difference.

What's more, our publication schedule has been on hyperdrive, with many new monographs and books by Murray Rothbard, Ludwig von Mises, F.A. Hayek—material long out of print but newly relevant—as well as a fantastic new book called *Boundaries of Order* by Butler Shaffer. Also, we are so pleased by a new book by Jeff Riggenbach: *Why American History is Not What They Say*. It is a long-overdue introduction to revisionist American history, and a real contribution. ■

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In his classic *Economics in One Lesson*, Henry Hazlitt defined “the art of economics” as the process of tracing out the consequences of any action or policy on all groups rather than on the groups the policy is intended to help. To protest that an empirical regularity, like corruption in government action, is unintended is not to excuse the policy in any meaningful way. Indeed, if a “well-intentioned” policy produces predictable responses in incentives, this strengthens the argument against the policy.

Individuals’ reluctance to volunteer suggests that service to the alleged moral rightness of the cause is not a sufficient compensating differential to those who are called to risk life and limb. Higgs describes this eloquently:

“The president and Congress were more eager to send men to war than men were to be sent, given the existing terms of service. Evidently no one in the government ever considered whether the desired number of volunteers could be obtained by making the deal sufficiently sweet.”

The debate occurred again before the beginning of World War II when “there

was a tremendous political struggle over conscription” where “(a)lmost no one took seriously the possibility of raising troops by offering recruits sufficient pay and perquisites.”

This would expose the costs of the war and likely provide a political check. Conscription, inflation, and price controls are more subtle and can create the perception of a shared burden.

The costs of war are understated by conscription because conscription of men naturally leads to conscription of property. The Selective Service Act of 1948 instituted a draft during peacetime, which Higgs called “an inefficient tax laid on the labor services and lives of certain unfortunate young men, by no means randomly selected.”

Our experience with conscription in the twentieth century teaches us valuable lessons about the desirability—or lack thereof—of conscription in the twenty-first century. Conscription was an unjust, capricious, and immoral disaster then. We don’t have any reason to think things will be different now. ■

# MEMOIRS

Ludwig von Mises

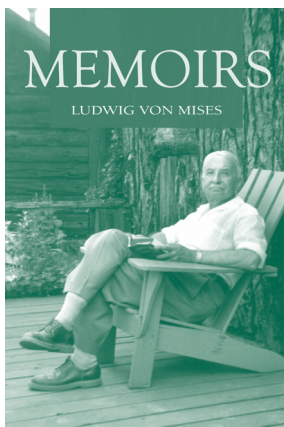
“HOW ONE CARRIES ON in the face of unavoidable catastrophe is a matter of temperament,” wrote Ludwig von Mises in his private memoirs of his life in Europe. It was true in his time and it is true in ours. This new translation and edition of Mises’s moving account of his life, published by the Mises Institute, provides not only a deeply fascinating personal history; it also functions as a moral and spiritual guide for any lover of liberty during times of despotism.

He was 59 years old, and a political exile, first from Vienna (fleeing the Nazi takeover) and then from Geneva. He had been camped out in Switzerland for six years, teaching and writing the masterpiece that would later become *Human Action*. But he had been warned that some people wanted him turned in. He had to find a new home.

Leaving Geneva, he and his wife Margit drove across France, just in front of the advancing German army. They barely made it out. There was no professorship waiting for him in the United States. He had lost everything. His library had been burned. His papers were missing. He had no money. He would have to start over, writing and speaking in a new language.

Despite being driven from his home, seeing his country taken over by a foreign dictator, having his books burned and his papers stolen, and finally pushed out of the sanctuary he had for six years, he never lost determination and never doubted the truth of liberty.

These are difficult times for those who love freedom. But they are nothing like what Mises faced during his life. He prevailed, and his memoirs explain how.



The book was written during and after his immigration to the United States in 1940. Mises wrote it and then promptly locked up the manuscript. He had good reason. Many of the politicians and intellectuals he exposed were still alive.

The vault that held the manuscript wasn’t opened until after his death in 1973. A German translation appeared with an introduction by F.A. Hayek. We commissioned a new translation that preserves his idiom and precision. The results are spectacular. Mises’s memoirs have come alive as never before. Guido Hülsmann wrote the preface, F.A. Hayek wrote the introduction, Arlene Oost-Zinner did the translation, but the book itself is pure Mises, writing his deepest and most private thoughts, now available to the world as an example, a model, and an ideal.

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