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The Stimulus Scam

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The recent improvement of the global economy, with particularly high economic-growth numbers for the United States, is just one more deception in a long series of deceptions that have plagued policy makers and investors. While official statistics register a rising gross domestic product, the long-term production potential of many economies around the world is actually contracting. The present economic expansion is brought about by massive stimulus policies. This kind of economic expansion does not constitute genuine economic growth.

It is quite common for policy makers, economic analysts, and commentators of all kinds to fail to distinguish between economic growth, which enlarges the productive capacity of an economy, and mere expansion of demand. Yet there is a huge difference between the kind of economic growth that comes as a consequence of victories in the battle against scarcity and the kind that is merely an output expansion resulting from increased spending.

The Austrian business-cycle theory emphasizes the problem of intertemporal misallocation due to monetary and fiscal stimuli. According to Austrian economic theory, stimulus packages induce the launch of projects that are bound to fail because their completion will be cut short by the lack of sustainable funding. In the short run, stimulus policies will bring an increase of the nation's gross domestic product, yet what matters for long-term economic growth is not credit-induced demand but the nation's capacity for production.

There is general agreement in the economics profession that the much-vaunted expenditure multiplier of Keynesian theory has quite different real and monetary effects depending on the state of the economy. However, the negative impact of stimulus policies on productivity is much less understood. When the economy expands due to fiscal or monetary stimulus, the productive capacity of the economy will actually decrease because the artificial expansion will mainly encourage malinvestment, i.e., the pursuit of business projects that are not viable in the long run.

It is easy indeed to fall into the trap of phony economic growth; as long as capacity utilization is below the normal level, demand expansions fueled by monetary and fiscal impulses increase economic activity. But the more the economy approaches full capacity, the more the effect on the production of real goods gets weaker and the effect on prices gets stronger. Eventually, this reaches the point when the monetary expansion only has inflationary price effects, and its impact on real production becomes nil.

When distortions in the economy are still small, and only a minor recession would be necessary to correct the misallocation, a modest amount of monetary or fiscal stimulus often will be sufficient to make the boom continue; this represents another source of deception. Central bankers and finance ministers enjoy praise for this cheap feat of having prevented what would otherwise have been only a mild and short slump. Yet by not letting mild recessions happen, these policy makers heap one pile of economic distortions upon another until the big downturn becomes unavoidable.

When finally confronted with the threat of a severe depression, these same authorities fall into panic. Acting in fear, they tend to deny experience and to flout prudence and rationality. In the face of a major economic downturn, monetary authorities resort to flooding the economy with even more easy money. Furthermore, their deficit spending heaps new debt upon old debt.

This pattern, which can be observed in many parts of the world, has also characterized US economic policy. By avoiding the small slump that most likely would have come after the stock-market crash of 1987, US monetary policy became highly expansive. It has continued that way ever since. Along the way, one bubble has followed the next, and consequently one bailout has led to the next.

After the economic dip of 2000, the US central bank's loose monetary policy laid the groundwork of the housing bubble. When the bubble burst, government implemented a series of stimulus packages, and monetary authorities set the interest rate down close to the zero bound. As of now, new packages are on their way and the Federal Reserve's reluctance to initiate its exit strategy is all too obvious.

As the collapse of the real-estate markets in the United States demonstrated, the credit boom has produced misallocations on a massive scale. The costs of many houses that were built when loans appeared easy to finance turned out to be unbearable. Projects that seemed to be financially manageable during the time of easy money had to be abandoned when the reality of scarcity was revealed. Investors and consumers were forced to retrench. Capital was lost, yet the debt burdens remain, and the fallout is felt throughout the entire economy.

As if economic history is to repeat itself, with each cycle getting worse, policy makers around the world repeat the old mistakes again and again. They have embraced, almost in unison, the rather crude belief that low interest rates and government spending will create wealth.

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In the 1970s, in the face of the first oil-price shock, many governments and economists had great expectations of the stimulus policies in Europe and the United States. But the result was global stagflation. Japan practiced fiscal and monetary expansion on a grand scale since its economy entered a recession in the early 1990s, and the result has been stagnation ever since.

Despite the colossal efforts to sustain the boom in Japan, Europe, and the United States, the systemic fragilities of the global financial markets have not vanished, and business bankruptcies and unemployment are on the rise. What has been accomplished, however, is the formation of unsustainable levels of debt and of excess reserves in the banking sector, which could explode at any moment into a surge of inflation.

Fabricating bogus economic growth is highly appealing to policy makers because they can easily produce such "growth" by wasteful consumption for war, welfare, and all kinds of popular government programs. Each stimulus package at first incites irrational jubilation but leaves behind a wasteland of failed projects and frustrated expectations. This mental discouragement of investors and consumers will linger on for years after the boom has ended.

While monetary spending is limitless, and there is no scarcity of zeros to add to the price tag, production remains limited by the scarcity of the factors of production.

Fake booms and their consequent busts are directly linked to financial cycles, which in turn reflect the swings in money creation. Fiat money lies at the heart of this process. Credit-based economic expansion and its consequent malinvestments create economic illusions. The true tragedy of a fiat money regime is that bogus economic growth by way of monetary and fiscal stimulus can go on only until either the collapse of hyperinflation brings an end to the artificial boom or the amount of accumulated debt makes state bankruptcy inevitable. FM

Garrett's Invaluable Lesson

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With the United States and much of Europe buried in public debt, many wonder how world governments will solve their impending budgetary crises. The economics profession has split into two camps: those who promote more spending; and their opponents, the "deficit hawks." The spenders have been the more vocal, largely due to their dominance in mainstream academia.

Keynesian economists, such as Paul Krugman, argue that growing debt will not be a problem given that large government debts are not unprecedented. For example, that the United States ran large debts during the Second World War and was able to pay them off after the war ended. This Princeton professor and Nobel laureate also argues that, because the United States is piling up debt, its public debt is justifiable and tenable.

Paul Krugman conveniently leaves out, or fails to apply, some key details. Regarding the Second World War, he notes that the debt was paid off largely because of a cut in government spending. He fails to account for the fact that the most dangerous factors behind the current debt are "unfunded liabilities"—the *future costs* of welfare and social-insurance programs. As for those other countries building debt, they are also looking at political uncertainty and almost-certain economic collapse.

Most onlookers have been able to see past these elementary flaws and realize the potential danger of growing public debt. Dismissing the Keynesian argument, however, leaves the layman with few other accessible explanations. For most, the biggest threat seems to be an increase in taxes. Although worrisome, high taxes should be the *least* of one's worries. The worst to come is sovereign default, a scenario which the mainstream has declared unrealistic.

Fortunately, the Austrian School's Garet Garrett chronicled the threat of accumulated public debt in *The Bubble that Broke the World*. Unfortunately, Garrett is the bearer of bad news.

The current situation is not unprecedented. High public and private debt has been the bane of large governments for the entirety of written history. It is what Ludwig von Mises described as the "crisis of interventionism."

"Intervention aims at confiscating the 'surplus' of one part of the population and at giving it to the other part. Once this surplus is exhausted by total confiscation, a further continuation of this policy is impossible."

Put in simpler terms, the crisis of interventionism is summed up by the adage, "the problem with socialism is that eventually you run out of other people's money."

While Mises laid down the theoretical foundations for the argument against big government and socialism, Garet Garrett provided the empirical evidence. In 1931, amidst a global economic crisis, Garrett published *The Bubble*. This relatively short book, largely forgotten today, provides one of the best and clearest arguments against the accumulation of public debt, and applies Mises's theory of the crisis of interventionism to the crisis in Central Europe during the Great Depression.

Garet Garrett remains an unsung hero of liberalism. Although he is probably best known for his novels, he was also a great economist. He worked to discredit the New Deal and Franklin Roosevelt, while crusading for small government.

The Bubble That Broke the World remains one of his most important works on economics and the Great Depression. Garrett placed the blame for the worldwide economic collapse of the 1930s on the Federal Reserve system's program of extending credit to bail out its European friends. He branded the entire process a Ponzi scheme.

Garrett described the bubble as a product of three factors:

"*First*, the idea that the panacea for debt is credit. The burden of Europe's private debt to [the United States] now is greater than the burden of her war debt; and the war debt, with arrears of interest, is greater than it was the day the peace was signed. . . .

"*Second*, a social and political doctrine, now widely accepted, beginning with the premise that people are entitled to certain betterments of life. If they cannot immediately afford them, that is, if out of their own resources these betterments cannot be provided, nevertheless people are entitled to them, and credit must provide them. . . .

"*Third*, the argument that prosperity is a product of credit, whereas from the beginning of economic thought it had been supposed that prosperity was from the increase and exchange of wealth, and credit was its product."

The late 1920s and early 1930s was a period of fear throughout Europe. Currencies were losing value, governments were building debt, and animosity was again quickly spreading between governments. European central banks were having issues remaining solvent while still providing liquidity to their governments. As a result, they often looked to the New York Fed and a host of private banks in the United States for credit to provide this liquidity.

Ultimately, the solvency of the Bank of England and the Reichsbank depended entirely on the solvency of the US Federal Reserve System. The Fed could only remain solvent as long as the Europeans repaid their debts, and by 1930 it was becoming obvious that these countries were borrowing far more than they could afford to repay.

Germany was the weakest link. Her government, scrambling for funds to pay for war reparations and social programs, borrowed copiously from English and American creditors. Unsurprisingly, the Germans began to borrow to pay for debts owed to the *same* creditors. Garrett described this as a method by which Americans were repaying themselves for debts owed by others. The long-run consequence was even greater German debt. The principal losers were the American creditors who had lent far too much credit to the Europeans.

The overall consequences were easy to predict. As European central banks became insolvent, they began to default on their debts, catalyzing the collapse of the giant pyramid of credit funded largely through the Federal Reserve Bank of New York.

The lesson of *The Bubble That Broke the World* is not the eventual collapse, per se. Although Garrett does argue that an accumulation of debt will end in insolvency, his focus is on the accumulation of debt itself. Garrett's lesson is that government expenditure funded through debt and credit expansion creates an addiction to credit. Credit is considered a panacea, and is used to keep government programs afloat. Building debt, fueled by addiction, leads to ruin.

Credit can serve as a panacea for debt only as long as there is credit available to borrow. When the source of credit has been depleted, and governments find it impossible to repay their bloated accounts, the house of cards collapses. This is what occurred in the early 1930s, and it is what will occur in the present day.

Although crises of interventionism have occurred between the 1930s and the present—including in Argentina and Zimbabwe—the majority of First World citizens remain distant from the concept. Apart from those few veterans of the Great Depression, the majority have lived in an era of abundant resources and unparalleled wealth. Despite the recurring booms and busts, there have been few serious periods of general poverty in the United States, nor in most of Western Europe.

Garrett's book was forgotten soon after it was published. Even Rothbard's *America's Great Depression*, which in many ways brought Garrett's insights out from obscurity, remains unheeded.

But the era of growing bureaucracy, of the welfare/warfare state, and of illusionary wealth cannot last forever. Today, we are witnessing the symptoms of an impending "crisis of interventionism." Garrett's lesson is as relevant and valuable as ever.

The West has undermined its own security by allowing its governments to quickly grow beyond the fiscal means of its people. The United States and Western Europe have built up a mountain of debt. Deficit spending as a countercyclical fiscal policy is the least of the world's worries. The collapse of today's credit-based Ponzi scheme is mainly due to the multitude of social-insurance programs that are becoming far too costly to sustain. In other words, the crumbling keystone is not short-term expenditure but long-term debt.

Given the political unpopularity of cutting these untenable programs, it is unlikely that governments will purposefully reverse their growth.

There is a fast-growing addiction to credit. Western governments can be compared to drug addicts. While a drug addict can overdose, however, the government can remain high as long as credit continues to be supplied at an exponentially rising rate. But, as with any addict, the day the supply cuts short is the day that marks the beginning of a severe depression.

But wait, if government can just print money, would it not be able to pay off its debt, even if at the expense of everybody else? This is why unfunded liabilities are so important. The cost of these social-insurance and welfare programs can increase with general price inflation. Government cannot print its way out of a debt that adjusts itself to the rise in the supply of money.

There is only one long-term solution, and that is the reduction of government. Large government is unsustainable. For better or for worse, the market corrects itself.

We have the Great Depression as a warning. But the bureaucrats who run governments have decided to ignore the lesson. The new crisis of interventionism is fast approaching, and the market will not wait for governments to realize their errors. FM

News from the Institute

Austrian Scholars Conference

The Austrian Scholars demonstrated the incredibly diverse program that is the Austrian tradition. We had presentations on our new and pathbreaking book, *Literature and the Economics of Liberty*, edited by Paul Cantor and Stephen Cox. Also, we had John Papola here, the gentleman who made that famous rap video on Hayek and Keynes. This was in addition to 200-plus attendees. FM

Upcoming Seminars

On April 10, in Phoenix, Arizona, the Mises Institute is presenting "The Inflationary Path to Despotism," sponsored by James Rodney, to provide an overview of the Misesian analysis of the current economic conditions, especially for people who might have heard of our work and would like to know more.

Also, back in Auburn, we have scheduled a seminar for high-school students on April 30, sponsored by Jeremy Davis. The first one was a great success (we eventually had to close registration for lack of space), and we also have high hopes for the second one. All high-school students are eligible to attend. There is no registration fee. FM

Coming Events
AT THE MISES INSTITUTE

Register for any conference online at mises.org or by phone at 800-636-4737.

- THE INFLATIONARY PATH TO DESPOTISM —THE MISES CIRCLE IN ARIZONA
  April 10 • Phoenix, Arizona • Sponsored by James M. Rodney
- WHY AUSTRIAN ECONOMICS MATTERS — ECONOMICS FOR HIGH-SCHOOL STUDENTS
  April 30 • Auburn, Alabama • Sponsored by Jeremy Davis
- AUSTRIAN ECONOMICS AND FINANCIAL MARKETS — THE MISES CIRCLE IN MANHATTAN
  May 22 • New York City
- ROTHBARD GRADUATE SEMINAR
  June 6–11, 2010 • Auburn, Alabama • Sponsored by Alice Lillie
- MISES UNIVERSITY
  July 25–31 • Auburn, Alabama
- MISES UNIVERSITY ALUMNI REUNION
  July 31 • Auburn, Alabama
- THE DELUSION OF GOOD GOVERNMENT — THE MISES CIRCLE IN COLORADO
  September 18 • Colorado Springs • Sponsored by Pike's Peak Economics Club
- FREEDOM THROUGH TECHNOLOGY — SUPPORTERS SUMMIT AND SCHLARBAUM AWARD TO JIM ROGERS
  October 8–9 • Auburn, Alabama
- ECONOMICS IN ONE LESSON — ECONOMICS FOR HIGH-SCHOOL STUDENTS
  November 19 • Auburn, Alabama • Sponsored by Anastasia Thiele
- AUSTRIAN SCHOLARS CONFERENCE
  March 10–12, 2011 • Auburn, Alabama

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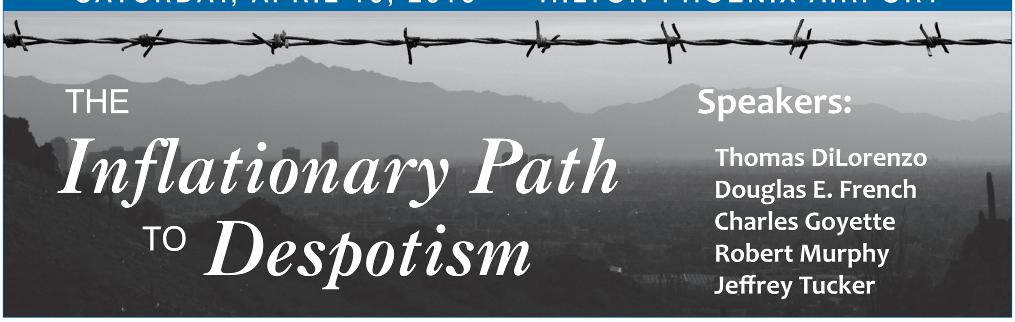

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