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Nonsense on Deflation

Robert Higgs

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We are now hearing ominous warnings about imminent deflation. Checking the welcome page at AOL this morning, I see that the lead item in the financial news section heralds "The Looming Threat of Deflation." This headline encapsulates two highly problematic ideas. The first is that deflation would necessarily be a bad thing. The second is that deflation is likely to occur in the near term.

That deflation is always and everywhere a bad thing—not simply a bearer of bad news but bad news in itself—is now an almost universal article of faith among mainstream economists and financial commentators. Clicking on the scary headline, I opened an article by Ted Allrich, who is described as "the founder of The Online Investor and author of the book *Comfort Zone Investing: Build Wealth and Sleep Well at Night*."

Allrich's article, which does nothing to alter my belief that most investment "experts" are simply charlatans, encapsulates virtually every untutored and fallacious idea you've ever encountered in regard to deflation.

As he tells the story, deflation brings on all the horrors in the catalog of economic devastation.

As prices decline, businesses sell less, then go out of business. Fewer goods and services are offered. Less doesn't become more. It becomes less.

As businesses fold, capital dries up because investors don't believe any business will make it, no matter what the product or service. Investors hang on to their cash. Hoarding becomes synonymous with survival. Wall Street (what's left of it) can't find capital for new companies to grow. Investors won't invest.…

So with deflation, there is less of everything. Businesses don't grow. Jobs are fewer. Capital is not available. Everything comes to a slow and grinding halt.

Allrich concludes his litany of deflation horrors, naturally, by singing the praises of inflation: "Regular inflation, in fact, can be a good thing since it suggests an ever growing economy where jobs are plentiful and goods and services abound. "

Well, all right, we can't expect Allrich to have read George Selgin's splendid little book *Less Than Zero: The Case for a Falling Price Level in a Growing Economy* (London: Institute of Economic Affairs, 1997), or Guido Hülsmann's *Deflation and Liberty* (Mises Institute, 2008). After all, investment experts are busy people.

But why, one wonders, has he not taken to heart what I wrote thirty-seven years ago in my first book, *The Transformation of the American Economy, 1865–1914* (New York: Wiley, 1971), on p. 21: "Notably, rapid economic growth occurred both before and after 1897; neither a falling nor a rising general price level was uniquely associated with economic growth."

To elaborate just a bit, the rate of economic growth from 1866 to 1897, a period of secular deflation, was perhaps the greatest ever experienced by the US economy during a period of comparable length. Real GDP grew by more than 4 percent per year, on average, notwithstanding the persistent deflation.

So, even if you've not mastered the works of Ludwig von Mises and Murray Rothbard, even if you are a confirmed positivist in your methodological bent (as I was in 1971), you can see clearly that the rate of economic growth and the rate of price-level change have been independent, at least within the ranges of these variables in US economic history.

(Hyperinflation or hyperdeflation would be another matter: either would be devastating by making economic calculation and long-term contracting virtually impossible.)

Any decent economics teacher makes sure that before the students have gone more than a week or two, they have mastered the difference between absolute (nominal) and relative (real) prices. All of economic analysis hinges on this understanding. Yet practicing politicians, investment gurus, news media hyperventilators, and others who play important roles in influencing public opinion are completely lacking in this basic understanding. The upshot is a destructive bias in favor of secular inflation, with the risk of periodic bouts of rapid inflation.

Which brings us to the second question: for better or worse, does deflation actually loom at present? If it does, its occurrence will surprise me greatly, because the Fed has been creating base money as if there were no tomorrow, and if the bailouts continue, as seems likely, more of the same is virtually certain.

So far, the huge spurt in base money has simply been absorbed and held by the banks in the form of (legally) excess reserves, but the likelihood that the banks will sit on $268 billion of excess reserves forever is nil. Once they feel more secure, their loans and investments will go forth in search of a higher yield than the Fed pays them (since a recent change in policy) on their reserves, and at that point the banking system's money multiplier will kick in with terrific force.

In short, given the monetary conditions now prevailing, the greater threat by far is inflation, not deflation. And contrary to what the investment "experts," the politicians, and the mainstream economists believe, inflation is not a benign element in the economy's operation. It is, as it has always been, the most dangerous and destructive form of taxation. ■

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The Market Works in Recession

Llewellyn H. Rockwell, Jr.

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One of the great and most persistent errors of classical liberals is to believe in "good government," a government that does "what it is supposed to do."

There is nothing the state can do, and which society needs done, that cannot be done far better by the market. Another point that is just as telling: no state empowered to do what is supposedly necessary will restrain itself to those things. It will expand as much as public opinion will tolerate.

Sometimes the point is easier to see when looking at foreign governments, such as the tragic case of China. The government is embarking on an explosive venture to dump $586 billion into "infrastructure" over two years. The reason is the classic Keynesian excuse: the spending is needed to stimulate investment. Never mind that this trick has never worked in all of human history. This is instead a grand plan to loot the private sector on behalf of the Communist Party, which will then spend the money bolstering its power.

No country knows more about the failures of this type of central planning than China. Every form of collectivism has been tried out on these poor souls, and tens of millions lost their lives in the course of Mao's insane collectivist experiments. That this new plan is being enacted in the name of Lord Keynes rather than Karl Marx is irrelevant. The effects are the same: expand power and reduce liberty.

China's recovery from communism is one of the most inspiring stories in the history of economic development. The country went from being a suffering and impoverished land of catastrophe to being modernized in just 15 years. The state shrunk in scope nearly by default as the private sector grew and grew. This wasn't the plan. It was the de facto result of the new tolerance of free economic activity. The state went into protective mode to keep its power, and did nothing to stop the swell of private enterprise. The result was glorious.

Keep in mind this critical point: China's restoration as a civilized society came about not due to some central plan, but by its absence. The fact that the state did not intervene led to prosperity. Again, it wasn't a policy or a constitution or a law that made the difference. There was no switch from a communist-style government to a night-watchman state. Because the state abandoned its posts under public opposition and contempt, society could flourish.

But the state never went away. It's just that its depredations have been spotty and unpredictable. Had history taken a better course, the central state would have melted away completely, and law would have devolved to the most local levels. Sadly for the Chinese, the state persisted in its old structure, even as the private sector grew and grew. The state still had its hand in the large industries such as steel and energy, and, of course, it controlled the banking sector.

The government never became good (an impossibility). It was and is bad. It was just less bad than in the past, because it did less. But all states lie in wait for a crisis. The earthquake in the southwest provided one great excuse for intervention. There is no greater excuse for state expansion than an economic crisis—except perhaps war.

Chinese officials can count on support from Western "experts" here, and the thoroughly disgusting US response to our own economic downturn has provided an awful model for the world. Think of it: the Communist Party in China is now citing the United States as the main reason for its plot to loot the private sector and bolster its own power at the expense of the country.

So much for being a beacon of liberty in a dark world! Instead, the United States is helping to shut out the lights and bolster decrepit despotisms. This is surely one of the great ironies of the current political moment. Instead of teaching the world about liberty, the United States' newly empowered unitary executive is christening various forms of dictatorship.

There can be no question that China's spending will not improve economic growth. It will instead extract $586 billion from the private sector and spend on political priorities. Never forget that no government has wealth of its own to spend. The money has to come from taxation, monetary inflation, or debt expansion that must be paid later. And government's spending choices will always be uneconomic relative to how society would use that wealth. That is to say, the money will be wasted.

But won't the spending spur investment? It can create local boomlets, but they will be temporary. To the extent that the new spending causes a spending response from investors and consumers, this is more evidence of an uneconomic use of scarce resources. If the money is used to prop up failing companies, that's particularly bad since it is an attempt to override market realities, an attempt that is about as successful as trying to repeal gravity by throwing things up in the air.

The nature of the state—and the core of its rationale for existence—is the conviction that it stands apart from and above society, to correct the failings of the market and individuals. A presumption of superiority is at the very heart of the state, whether it is minimal or totalitarian.

Who is to say when and where it should intervene? Well, think about it. If the state is inherently wiser than and superior to society, standing in judgment over what is working and what is not working, the state alone is also in a position to decide when it should intervene.

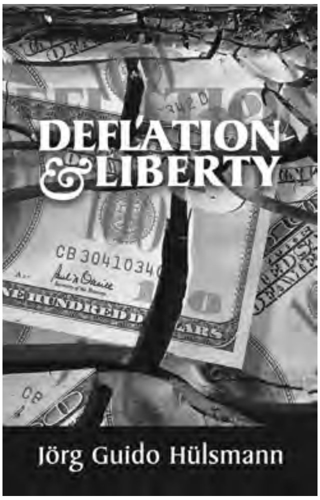
No government is liberal by nature, said Ludwig von Mises. This is the great lesson that people who advocate "limited government" have never learned. If you give the government any jobs to do, it will presume the right to police its own conduct and then inevitably abuse its power. That is true in China and it is true in the US.

It was the science of economics that first discovered the radical incapacity of the state to make any improvements in the social order. It turns science on its head to invoke economics as a reason for the government to loot and pillage in the name of "stimulating investment." Stimulation here, there, and everywhere amounts to a diminution of freedom, security of property, and prosperity.

Keynes famously praised Nazi economic policies in the introduction to the German edition of his worst book, the *General Theory*. After a century of horrors, free men and women in China, the US, and the world surely deserve better. ■

News from the Institute

Truth about Deflation

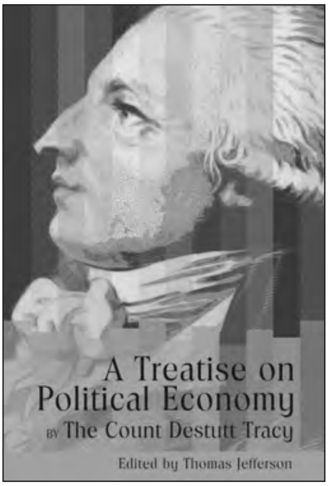


With the news media throwing a fit about deflation, J.G. Hülsmann's *Deflation and Liberty* appears just in time. He wrote it to explode the fallacies of our day, but he also makes an important contribution to our knowledge of the subject. He points out that a free-market deflation does a lot of good for both the political system and the economy generally.

The essay covers a surprisingly vast theoretical territory in a short space, including the nature of money and interest, the boom and bust, the impossibility of stabilization measures, and the economic trends of the recession. He goes further than any previous writer in arguing that no measures of any kind should be undertaken to cure the bust through money creation, even under conditions of falling prices and falling money stock. His rationale is both economic and political. ■

Destutt de Tracy!

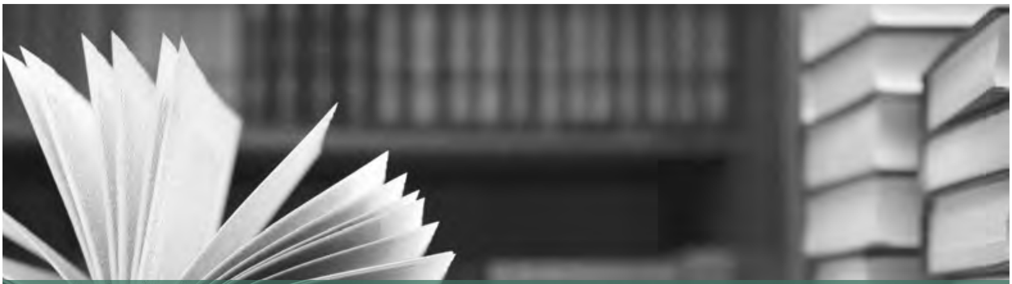
The neglect of Antoine Louis Claude Destutt de Tracy (1754–1836) in the history of political economy is both strange and tragic. He was, after all, Thomas Jefferson's number one, favorite economist, the thinker who influenced him and, arguably, laid the ideological foundation of the American economic system as Jefferson understood it.



What's more, the Mises Institute reprint of the 1817 edition of his *Treatise on Political Economy* was prepared personally by Jefferson and contains an editorial note by him.

"It would be difficult to do justice, in any translation, to the style of the original, in which no word is unnecessary, no word can be changed for the better, and severity of logic results in that brevity, to which we wish all science reduced. The merit of this work will, I hope, place it in the hands of every reader in our country. By diffusing sound principles of *Political Economy*, it will protect the public industry from the parasite institutions now consuming it, and lead us to that just and regular distribution of the public burthens from which we have sometimes strayed."

This high praise from Jefferson has somehow not translated into deserved fame for this book. One reason for this has to do with Tracy's own radicalism. ■



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