

FREEMarket

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THE WAR ON RECESSION

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We all want to live well and no one wants their living standard to decline. No one likes recession. It's just the way we are made. This is one reason that the official environmentalist movement has an uphill battle. The poverty that comes with living without industrial civilization lacks public support—once people clue in that this is what they are after.

At the same time, a major contribution of the Austrian School is that recessions do not appear in a vacuum. They are a response to an economic imbalance that is part of the boom phase of the business cycle—a boom characterized by unsustainable investment made possible by the artificial expansion of money and credit. In this sense, recessions are not only inevitable; they are necessary, and, in an economic sense, a welcome turn of events.

What does not make any sense is the strange article of faith that has descended over Washington, DC, that says that no prices must ever be permitted to decline due to recessionary pressures. All resources in the national treasury, every conceivable monetary manipulation, all efforts of every regulatory body must be marshaled toward the great national goal of re-pumping the economy, which must never ever be permitted to fall even a tiny bit.

Welcome to the War on Recession, which is being pursued with the same vehemence and folly as the War on Terror, and will likely prove just as spectacularly destructive of its own aims as well as liberty itself. Maybe we need songs, banners, and little ribbon pins too.

Let's think about the big picture. The economy was overinflated due to reckless monetary policy and government agencies treating critical sectors such as housing as a democratic right and thereby too big to fail. The trend dates back decades but the bubble became insanely large only within the last 5–10 years. Something had to give. And it turns out that this was just the beginning. All sectors were puffed up and inflated.

Can we agree that there was a problem—that not all was well, despite appearances? I think we can. So what do we do in this case? There has to be a downward correction, but there's no reason to panic. A good correction is just what a recovery needs to get going. Such is the nature of the Fed-created business cycle.



So what could it possibly mean to claim that the economy must never be allowed to fall into recession? I'm thinking here of similar claims: "That drunk is sobering up. Quick, give him a shot of tequila!" "That druggie is coming out of his trip. Get the syringe!" "Don't look now but that insomniac is going to sleep. Someone wake him!"

Now, it's fair to say that the person hollering out the solution to each of the above scenarios doesn't really understand the nature of the problem.

So it is with the Fed. It sees stocks falling, credit markets under pressure, unemployment rising, investment falling. But rather than conclude that all these factors represent a bubble, it has the opposite response: keep the bubble inflated at all costs!

It's time that we question the very foundations of this war on recession. The recession is a regrettable but inevitable backlash against a boom that was not justified by the fundamentals.

That last phrase is the critical thing. I am not saying that the recession is the price we pay for economic growth. Boom times are fabulous times, provided that they are rooted in sound fundamentals. And what are those? Essentially it is this: the timeframe of investment must match the timeframe of society at large. If people are long-term oriented and saving money, resources become available for investment in the future. When production is completed, there are consumers to buy. But if no one is saving money and there is no sound store of capital, there are no resources to invest—unless, of course, the Fed creates that money. The money the Fed creates is wholly illusory, a fiction of

investors' imaginations. It will vanish when the economy wakes up to reality.

This is an example of investment unjustified by fundamentals. What to do in that case? There must be a correction. There is nothing the Fed or the Congress can do about it. They certainly shouldn't attempt to prevent it. To attempt to prevent the correction is like turning into the skid: it only makes it worse.

All this nonsense about digging ourselves out of recession through government intervention began with the New Deal. Before then, government didn't do much at all about the downside of the business cycle. And guess what? Recessions were short and less than lethal for economic health. Indeed, they were the essential foundations of future recovery. All that changed with FDR, who used the economic downturn as the great excuse to make himself the economic führer of America.

But here is the amazing fact: *not once has this strategy worked.*

Not in the New Deal. Not in the 1970s. Not in the 1980s. Not in the 1990s. Not once has government done anything to restore prosperity during a slump. What happens again and again is that government spends, the Fed inflates, the regulators punish, there is wailing and gnashing of teeth, and then, at some point, we hit bottom, and normalcy begins to return again. The most government can do is prolong the period at the bottom. Otherwise, it is just wasting resources.

Take a look at Murray Rothbard's book *The Panic of 1819*. Here we have America's first big financial panic. The public was going nuts demanding answers. Congressmen proposed this

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and that. Debates raged in the papers. But government ultimately took no action at all. Sure enough, the panic went away on its own. So it was in 1920 and 1921. The government didn't intervene and *voilà* normalcy returned.

Here's another strange thing about this antirecession mania: for years we've been hearing from the environmentalists that we need to live more simply, do without, cut back, drive bikes not cars, and generally lower our standard of living and look after the well-being of plants and lizards and things. It turns out that Americans don't really go for this message. A slight downtick in the price of the house causes hysteria.

So as we look forward to the recession, we might consider two possible linings of silver. In sectors with lower prices, this is a saving grace for consumers. House prices will fall, and many stocks too. These are all buying opportunities in times when the prices of many goods such as oil and gas are inflated. Second, during recessions, the environmentalists won't get very far with their message that we should embrace poverty and call it our own. I don't expect that much progress will be made in calls for ending the use of fossil fuels on the speculative hope that this will cool the planet. ■

BENNIE AND THE MONETARY JETS

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The old monetarist tale of the Great Depression, thoroughly refuted in the Austrian literature, is that the Federal Reserve failed to provide enough inflation (i.e., money supply) when the market started to weaken and it allowed the money supply to collapse, and, as a result, the banks failed and the economy went into a tailspin of depression.

The monetarists believe that the Federal Reserve acted properly during the 1920s in maintaining price-level stability by providing the banking system with regular injections of money. This despite the fact that the decade was called the "Roaring Twenties," that unemployment was unnaturally low, and that anyone looking at a graph of the stock market could clearly see a bubble in the making.

The new chairman of the Federal Reserve, Professor Ben Bernanke, is a student of the Great Depression and has written extensively on the subject. He famously said (as vice chairman of the Fed) at Milton Friedman's 90th birthday, not to worry, Milton, "We won't let it happen again."

So now that he is chairman of the Fed, he faces the task of trying to clean up the housing bubble and prevent the economy from slipping into depression.

It's a daunting task and he is evidently dedicated to one tactic: inflation now and forever.

Foreclosures and bankruptcies are on the rise, the credit markets are tightening because no one is sure who is holding all the bad mortgage debts, and banks are naturally risk averse with all the signs of

recession, including a recent jump in the unemployment rate.

In addition, the dollar is at all-time lows against foreign currency. Oil is over \$100 per barrel, and gold hovers at \$1,000 per ounce. Price inflation at consumer and wholesale levels is rising even according to government statistics. Every time the Fed cuts rates, it only makes these problems worse and undermines the value of the dollar. This is also a big problem for Bernanke because, in addition to promising no depression, he supports inflation targeting where core consumer prices rise by no more than 2 percent per year.

The supposed lesson of the Great Depression looms always: the Fed tried to inflate but the banks wouldn't help. This time the Fed must find a work-around. Bernanke's technical solution is rather novel. It amounts to bribing the banks to take the money.

It is not surprising that banks don't want to lend heading into a recession. It is also quite natural that banks do not want to lend their reserves to other banks when they do not know their exposure to the subprime crisis. In addition, with all this uncertainty it is also not surprising those banks are reluctant to go to the Fed's discount window for reserves, because then you reveal that you are in trouble, and subsequently your stock price gets hammered, and all of your customers and creditors get nervous.

At the discount window, banks can temporarily exchange some of their assets for cash for which they pay the Fed the "discount rate" of interest. Actually, in researching this article, I found out that the Fed discontinued the "discount rate" data series years ago and failed to notify the public. They now chronicle a data series called the "primary credit rate" (this is not the "prime rate"). Even banks in financial difficulties can borrow "secondary credit" at a slightly higher interest rate.

So how does Bernanke jump-start the banking system? Bernanke decided that,

instead of waiting for timid customers at the discount window, he would announce a series of auctions called Term Auction Facilities, or TAFs, where the high bidders would get the bank reserves. This maintains the bank's privacy, or at least reduces the onus of approaching the discount window, and it guarantees that new reserves will enter the system.

According to the Fed: "The TAF is a credit facility that allows a depository institution to place a bid for an advance from its local Federal Reserve Bank at an interest rate that is determined as the result of an auction. By allowing the Federal Reserve to inject term funds through a broader range of counterparties and against a *broad range of collateral* than open market operations, this facility could help ensure that liquidity provisions can be disseminated efficiently even when the unsecured inter-bank markets are under stress." [emphasis added]

What this accomplishes is that it almost guarantees that banks and a "broader range of counterparties" will get injected with new reserves from the Fed and reduce their need to hold traditional reserves from their customers' accounts. Also, it provides banks with the opportunity to put up a "broader range of collateral" for the loans at the discount window, including performing subprime mortgages!

Some commentators say that the Fed has merely taken charge, rising to the occasion, and attempting to "shake it loose together." However, others would say this is all an act of desperation. If desperate circumstances call for such drastic actions, then Bernanke's actions—rather than words—indicate that we are in desperate circumstances.

Whatever the case, while merchants and consumers wail about the lack of credit and high interest rates, the banks are getting rate cuts and credit mainlined via the Term Auction Facility. The Fed's

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News from the Institute

The Austrian Scholars Conference

This year's Austrian Scholars Conference was a wonderful event in which attendees heard and commented on presentations of new research in the Austrian tradition. Attendance was the highest it has been in years, and the sessions packed in more papers and presentations than ever before. Having expanded the program from two days to three several years ago, it now seems that this expansion was certainly necessary.

The program has a focus that is different from any other at the Mises Institute—not so much teaching or public outreach but the internal development of the most academic side of the Institute's work. It brings together faculty members from different disciplines (but of course focusing on economics). For many of these professors, this is the only time of the year when they can have face-to-face intellectual interaction with others who share their basic assumptions about social and economic theory.

It is impossible to overestimate the importance of an event like this. It stimulates new research, improves existing research. People make connections with others working in their own field. They come to appreciate the vast applications that are possible within the Austrian tradition. They make friends, and feel emboldened in their own work. This is why Austrians have come to depend so heavily on this conference.

We had excellent named lecturers this year. Larry Sechrest spoke on the persistence of anticapitalism. Martin Fridson discussed his new book on the failure of the state. Lorenzo Infantino spoke on the influence of Hayek on his own thinking. Stephan Kinsella presented a challenging call to completely rethink intellectual property law.

In addition, there were panels on monetary reform, regulation, the history of thought, method, development economics, sociology, privatization, religion and economics, and many other areas. We heard reports on new books, saw manuscripts of new papers, and had dozens of lively debates and Q&A sessions.

Your investment in this invaluable program will pay big dividends in the academic world and the students these professors reach. Please consider making a tax-deductible contribution toward this program, either online at Mises.org or using the enclosed envelope. ■

The New Mises.org

The Mises website has undergone a massive upheaval in the last few weeks, one of the most extensive in its 13-year history. The vast amount of information on Mises.org—audio, video, books, bookstore, library, and so much more—is more accessible than it has ever been, and the traffic increase reflects that. Take a visit and see what is new. ■

Economics in One Lesson

If we could isolate one publishing project that has us fired up this quarter—one among dozens!—it would have to be the new edition of *Economics in One Lesson* that will soon be ready to ship from our warehouse. This is the first edition, completely reset. It is the first hardback to be available in decades. And the price, thanks to donor underwriting, makes it a candidate for mass distribution. It is the *perfect* introduction to economics. You will want to keep ten or so on hand at all times to hand out. ■

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policies have also greatly reduced interest rates for savers in their savings and checking accounts, certificates of deposit, and money market accounts.

It should come as no surprise to readers that the auction rate is less than the old discount rate. Every winning bid in the first six auctions has been below the discount rate, usually by more than half a percentage rate. Lower rates and the cover of darkness—this is a nice deal for

the banks. Bank borrowing from the Fed is so large that it is actually greater than their total reserves on hand.

The important question is, who's right and who's wrong? Can Bennie make the banks and the bad debts ageless? Can he live up to his promise to Milton Friedman and maintain his inflation targeting promises? It would seem that he has put the faith in monetarism and government-managed money on the line. So stick around to find who's right and who's wrong. ■

Capitalism the Creator

THE MISES CIRCLE IN SEATTLE



A CURT AND ALLORA DOOLITTLE SEMINAR • MAY 17, 2008

The Mises Circle goes to Seattle to address contemporary issues in liberty, and the role of capitalism as the main force for every form of progress in our age. We live amidst its fruits—technology, culture, philanthropy, human well-being—and have yet to appreciate the source. Indeed, among the most passionate opponents of the free market are those who have benefitted most enormously from it.

We will be meeting from 9:00 a.m. until 2:00 p.m. at Maggiano's Little Italy Restaurant, 10455 NE 8th Street in Bellevue. Refreshment breaks and lunch are included in the registration fee of \$75.

Speakers and Topics:

Walter Block • Legalize Consenting Capitalist Acts

Thomas Woods • The Calamity of Anti-Capitalism: A Brief American History

Lew Rockwell • Everything You Love You Owe to Capitalism

James Fogal, CFP® will also be available to discuss tax savings.

For accommodations, call Westin Bellevue before April 15 (600 Bellevue Way, N.E. adjacent to Maggiano's), 888-627-8084 and mention the Mises Institute for a special rate of \$149 per night plus tax, single or double.

The Mises Store will be open throughout the seminar, and speakers will be happy to autograph books.

For more information, contact Patricia Barnett (pat@mises.org) or phone 334-321-2101.

UPCOMING EVENTS

- THE MISES CIRCLE IN SEATTLE (Sponsored by Curt and Allora Doolittle)
May 17, 2008 • Seattle, Washington
- ROTHBARD GRADUATE SEMINAR (Sponsored by Alice J. Lillie)
June 8–13, 2008 • Auburn, Alabama
- MISES UNIVERSITY
July 27–August 2, 2008 • Auburn, Alabama
- THE MISES CIRCLE IN VANCOUVER
(Sponsored by Morgan Poliquin, Almaden Minerals)
September 13, 2008 • Vancouver, B.C., Canada
- ANNUAL SUPPORTERS SUMMIT AND SCHLARBAUM AWARD
October 31–November 1, 2008 • Auburn, Alabama
- THE MISES CIRCLE IN HOUSTON (Sponsored by Jeremy S. Davis)
January 24, 2009 • Houston, Texas
- AUSTRIAN SCHOLARS CONFERENCE
March 12–14, 2009 • Auburn, Alabama



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