Etceteras . . .

Recession and Recovery

Six Fundamental Errors of the Current Orthodoxy

ROBERT HIGGS

As the recession has deepened and the financial debacle has passed from one flare-up to another during the past year and a half, commentary on the economy's troubles has swelled tremendously. Pundits have pontificated; journalists and editors have reported and opined; talk radio jocks have huffed and puffed; public officials have spewed out even more double-talk than usual; awkward academic experts, caught in the camera's glare like deer in the headlights, have blinked and stumbled through their brief stints as talking heads on TV. We have been deluged by an enormous outpouring of diagnosis, prognosis, and prescription, at least 95 percent of which has been appallingly bad.

The bulk of it has been bad for the same reasons. Most of the people who purport to possess expertise about the economy rely on a common set of presuppositions and modes of thinking. I call this pseudointellectual mishmash "vulgar Keynesianism." It's the same claptrap that has passed for economic wisdom in this country for more than fifty years and seems to have originated in the first edition of Paul Samuelson's *Economics* (1948), the best-selling economics textbook of all time and the one from which a plurality of several generations of college students acquired whatever they knew about economic analysis. Long ago, this view seeped into educated discourse, writing in the news media, and politics, and established itself as an orthodoxy.

Unfortunately, this way of thinking about the economy's operation, in particular its overall fluctuations, is a tissue of errors of both commission and omission. Most unfortunate have been the policy implications derived from this mode of

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The Independent Review, v. 14, n. 3, Winter 2010, ISSN 1086–1653, Copyright © 2010, pp. 465–472.

thinking, above all the notion that the government can and should use fiscal and monetary policies to control the macroeconomy and stabilize its fluctuations. Despite having originated more than half a century ago, this view seems to be as vital in 2009 as it was in 1949.

Let us consider briefly the six most egregious aspects of this unfortunate approach to understanding and dealing with economic booms and busts.

Aggregation

John Maynard Keynes persuaded his fellow economists and then they persuaded the public that it makes sense to think of the economy in terms of a handful of economy-wide aggregates: total income or output, total consumption spending, total investment spending, and total net exports. If people remember anything from their introductory economics course, they are most likely to remember the equation:

$$Y = C + I + G + (X - M).$$

Sometimes $Q \cdot P$ is equated to the variables on the right-hand side of the equation. So the idea is that aggregate supply (physical output times the price level) equals aggregate demand equals the sum of four types of money expenditure for newly produced final goods and services.

This way of compressing diverse, economywide transactions into single variables has the effect of suppressing recognition of the complex relationships and differences *within* each of the aggregates. Thus, in this framework, the effect of adding a million dollars of investment spending for teddy bear inventories is the same as the effect of adding a million dollars of investment spending for digging a new copper mine. Likewise, the effect of adding a million dollars of consumption spending for movie tickets is the same as the effect of adding a million dollars of consumption spending for gasoline. Likewise, the effect of adding a million dollars of government spending for children's inoculations against polio is the same as the effect of adding a million dollars of government spending for 7.62-millimeter ammunition. It does not take much thought to conceive of ways in which suppression of the differences within each of the aggregates might cause our thinking about the economy to go seriously awry.

In fact, "the economy" does not produce an undifferentiated mass we call "output." Instead, the millions of producers who bring forth "aggregate supply" provide an almost infinite variety of specific goods and services that differ in countless ways. Moreover, an immense amount of what goes on in a modern market-oriented economy consists of dealings among producers who supply no "final" goods and services at all, but instead supply raw materials, components, intermediate products, and services to one another. Because these producers are connected in an intricate pattern of relations, which must assume certain proportions if the entire arrangement is to work effectively, critical consequences turn on what *in particular* gets produced, when, where, and how.

These extraordinarily complex microrelationships are what we are really referring to when we speak of "the economy." It is definitely not a single, simple process for producing a uniform, aggregate glop. Moreover, when we speak of "economic action," we are referring to the *choices* that millions of diverse participants make in selecting a course of action and setting aside a possible alternative. Without choice, constrained by scarcity, no true economic action takes place. Thus, vulgar Keynesianism, which purports to be an economic model or at least a coherent framework of economic analysis, actually excludes the very possibility of genuine economic action, substituting for it a simple, mechanical conception—the intellectual equivalent of a baby toy.

Relative Prices

Vulgar Keynesianism takes no account of relative prices or changes in such prices. In this framework, there is only one price, which is called "the price level" and represents a weighted average of all the money prices at which the economy's countless actual goods and services are sold. (There is also the rate of interest, which is treated as a price in a limited and misleading way, and about which I say more later.) If relative prices change—which of course they always do to some extent, even in the most stable periods—these changes are "averaged out" and affect the calculated change, if any, in the aggregate price level only in a shrouded and analytically irrelevant manner.

So if the economy expands along certain lines, but not along others, and the configuration of relative prices has changed, the vulgar Keynesians know that "aggregate demand" and "aggregate supply" have risen, but they have no idea why or in what manner they have risen. Nor do they care. In their view, the economy's aggregate output, the only output they treat as worthy of notice, is driven by aggregate demand, to which aggregate supply responds more or less automatically, and it matters not whether only the demand for cucumbers has risen or, to cite an example Keynes himself used, only the demand for pyramids has risen. Aggregate demand is aggregate demand is aggregate demand.[1]

Because the vulgar Keynesian has no conception of the economy's *structure of output,* he cannot conceive of how an expansion of demand along certain lines but not along others might be problematic. In his view, one cannot have, say, too many houses and apartments. Increasing the spending for houses and apartments is, he thinks, always good whenever the economy has unemployed resources, regardless of how many houses and apartments now stand vacant and regardless of what specific kinds of resources are unemployed and where they are located in this vast

1. In *The General Theory,* Keynes wrote: "Pyramid-building, earthquakes, even wars may serve to increase wealth" (1936, 129). Provoked by the Keynesian affinity for pyramid building, Paul Cantor quips: "If Keynes liked the pyramids, there had to be something wrong with them, and indeed there seems to be a connection between liking the pyramids and liking Big Government" (2002).

land. Although the unemployed laborers may be skilled silver miners in Idaho, it is supposedly still a good thing if somehow the demand for condos is increased in Palm Beach because for the vulgar Keynesian there are no individual classes of laborers or separate labor markets: labor is labor is labor. If someone—whatever his skills, preferences, or location—is unemployed, then in this framework of thought we may expect to put him back to work by increasing aggregate demand sufficiently, regardless of what we happen to spend the money for, whether it be cosmetics or computers.

This stark simplicity exists, you see, because aggregate output is a simple increasing function of aggregate labor employed:

$$Q = f(L), \text{ where } dQ/dL > 0.$$

Note that this "aggregate production function" has only one input, aggregate labor. The workers seemingly produce without the aid of capital! If pressed, the vulgar Keynesian admits that the workers use capital, but he insists that the capital stock may be taken as "given" and fixed in the short run. And—a highly important point—his whole apparatus of thought is intended exclusively to help him understand this short run. In the long run, he may insist, we are "all dead," as Keynes put it,[2] or he may simply deny that the long run is what we get when we place a series of short runs back to back. The vulgar Keynesian in effect treats living for the moment, and only for it, as a major virtue. At any given time, the future may safely be left to take care of itself.

The Rate of Interest

The vulgar Keynesian may care about the rate of interest, but only in a restricted sense. For him, the rate of interest is the "price of money"—that is, the rental rate paid on borrowed money. Such borrowing is always good, and more of it is always better because individuals use borrowed money to purchase consumer goods, thereby "creating jobs," and a job is the finest thing in the known universe. Hence, the lower the rate of interest, the more people will borrow and spend, and the better the economy will function, again so long as any unemployment exists anywhere in the country. Because some unemployment always exists, the vulgar Keynesian always wants the rate of interest to be lower than it is. If it can be lowered artificially by central-bank action, he strongly favors such action. The Federal Reserve System has recently pushed its target for the interest rate on "federal funds"—overnight balances the banks borrow from one another—to a range that begins at zero, and esteemed

2. Keynes's oft-quoted statement is actually not quite as ridiculous as it is usually made to seem. His statement in context, in the 1923 *Tract on Monetary Reform,* is: "The long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is past the ocean is flat again." The quotation is available at http://en.wikiquote.org/wiki/John_Maynard_Keynes.

economists have toyed with the crackpot notion of aiming for a negative rate of interest (see, for example, Mankiw 2009). (Where do I sign up for a loan?)

The vulgar Keynesian does not understand what the rate of interest really is. He fails to comprehend that it is a crucial *relative price*—namely, the price of goods available now relative to goods available in the future. Remember, he does not think in terms of relative prices at all, so it is entirely natural that he fails to recognize how the rate of interest affects the choice between current consumption and saving—that is, acting so as to make possible more future consumption by not consuming current income. In a free market, a reduction in the rate of interest reflects a desire to shift more consumption from the present to the future.

A free market would comprise private suppliers and demanders of loanable funds, and the prevailing market rate of interest would be that at which the amount demanders want to borrow equals the amount suppliers want to lend. Both borrowers and lenders, however, are making their choices in the light of their "time preference," which is to say the rate at which they are willing to trade present goods for future goods. People with a "high rate of time preference" are keen to consume now rather than later, and to induce them to give up present consumption, borrowers must compensate them by paying a high rate of interest for the use of their funds.

Although vulgar Keynesians recognize that a lower rate of interest will spur business firms to borrow more money and invest it, they imagine that business investment plans are naturally volatile and essentially irrational—driven, as Keynes said, by the entrepreneurs' "animal spirits" (1936, 161–62). Hence, the degree to which investment responds to a change in the rate of interest is small and may be more or less disregarded. For the vulgar Keynesians, the importance of the rate of interest is that it regulates the amount that individuals will borrow to finance their purchases of consumer goods. Those purchases, in their view, are the essential element in the determination of how much firms want to produce and how much they want to invest in expanding their capacity to produce. Again, however, in this framework, it matters not what kind of investment takes place: investment is investment is investment.

Capital and Its Structure

As noted already, the vulgar Keynesian views the capital stock as "given." If he thinks about it at all, he considers it a sort of massive inheritance from the past and assumes that nothing that might be added to or subtracted from it in the short run will change it enough to warrant concern. But if he gives little thought to capital, he gives none at all to its *structure:* the fine-grained patterns of specialization and interrelation among the countless specific forms of capital goods in which past saving and investment have become embodied. In his framework of analysis, it matters not whether firms invest in new telephones or new hydroelectric dams: capital is capital is capital.

Because in this framework the structure of the capital stock is disregarded—even sophisticated economists, such as Frank Knight, have insisted that the capital stock is essentially an undifferentiated glob of monetary value, any part of which may be substituted perfectly for any other part of equal monetary value (Hennings 1987, 330)—no attention is given to how changes in the rate of interest bring about changes in the structure of the capital stock. After all, what possible difference can such a change make? This willful blindness has caused many economists, including the most recent Nobel laureate, Paul Krugman (1998), to misinterpret the Austrian theory of the business cycle as a theory of "overinvestment," which it definitely is not.

Instead, the theory pioneered by Ludwig von Mises and F. A. Hayek in the first half of the twentieth century—a theory that fell into near oblivion after the Keynesian revolution in macroeconomics—is a theory of *malinvestment,* which is to say a theory of how an artificially reduced rate of interest leads business firms to invest in the *wrong kinds* of capital, in particular the longest-lived capital goods, such as residential and industrial buildings, as opposed to inventories, equipment, and software with a relatively short life. Thus, in the Austrian view, Fed-induced low rates of interest, like those between 2002 and 2005, led firms to overvalue longer-term capital projects and to shift their investment spending in that direction—producing booms in building construction, among other things. This shift would make economic sense if the interest rate had fallen in a free market, thereby signaling that people wish to defer more consumption by saving more of their current income. But if people have not changed their preferences in this way and continue to prefer present consumption relatively as much as they did previously, then businesses will make mistakes by choosing these kinds of investment projects, which are, in effect, attempts to anticipate future demands that will never eventuate. When the projects ultimately begin to fail, the boom that the artificially lowered interest rates set in motion will collapse into a bust, with attendant bankruptcies and unemployed labor, as unsustainable projects are liquidated and resources shifted, painfully in many cases, to more viable uses.

Because the vulgar Keynesian is blind to these microdistortions and to the need for their correction in the wake of an artificially induced boom, he fails to see any need for the bankruptcies and unemployment that necessarily attend a substantial economic restructuring. He supposes: if only the government stepped in and used its own deficit spending to make up for the reduced private investment and consumption spending, then business would be restored to profitability and workers reemployed *without any economic restructuring.*

It comes as no surprise, then, that people who think along such lines are currently working to continue a policy that contributed greatly to producing the unsustainable boom of 2002–2006, namely, subsidized lending to would-be homeowners who cannot meet normal commercial qualifications for receiving such loans. It does not occur to the vulgar Keynesians that too many resources have been directed into house and condo construction and that lending to homeowners who cannot afford to purchase homes unless they are subsidized to do so signals an uneconomic use of resources at the expense of the taxpayers who directly or indirectly finance these subsidies.

Malinvestments and Money Pumping

With their great, simple faith in the efficacy of government spending as a macroeconomic balance wheel, vulgar Keynesians disregard malinvestment, past and future, and support government spending in excess of the government's revenues, the difference being covered by borrowing. Of course, they favor central-bank actions to make such borrowing cheaper for the government. In fact, they chronically prefer "easy money" to more restrictive central-bank policies. As noted previously, they prefer easy money not only because it lowers the visible cost of financing the government's deficit spending, but also because it induces individuals to borrow more money and spend it for consumption goods—such increased consumption spending's being viewed as always a good thing, notwithstanding the near-zero rate of saving by individuals in the United States in recent years. Reflecting on the vulgar Keynesian attitude toward Fed policy, I keep recalling an old country song whose refrain was "older whiskey, faster horses, younger women, more money."

Vulgar Keynesians do not spend much time worrying about potential inflation; on the contrary, they are obsessed with an irrational fear of even the slightest hint of *de*flation. If inflation should become an undeniable problem, we may count on them to support price controls, which, on the basis of sketchy knowledge of such controls during World War II, they are convinced can be made to work well.

Regime Uncertainty

Vulgar Keynesians are nothing if not policy activists. Like Franklin D. Roosevelt, they believe that the government should "try something," and if it doesn't work, try something else (Roosevelt 1933, 51). Better still is that the government try a bunch of things at once and, if they don't turn the trick, then continue to pour more money into them anyway and try something else to boot. The eras they esteem as the most glorious ones in U.S. politicoeconomic history are Roosevelt's first term as president and Lyndon B. Johnson's first few years in the presidency. In these periods, we witnessed an outpouring of new government measures to spend, tax, regulate, subsidize, and generally create economic mischief on an extraordinary scale. The Obama administration's ambitious plans for government action on many fronts fill vulgar Keynesians with hope that a third such Great Leap Forward has now begun.

The vulgar Keynesian does not understand that extreme policy activism may work against economic prosperity by creating what I call "regime uncertainty," a pervasive uncertainty about the very nature of the impending economic order, especially about how the government will treat private-property rights in the future

(Higgs 1997). This kind of uncertainty especially discourages investors from putting money into long-term projects. Such investment, which almost disappeared after 1929, did not recover fully until after World War II. More than one observer has commented in recent months that regime uncertainty has resulted from the government's frenetic series of bailouts, capital infusions, emergency loans, take-overs, stimulus packages, and other extraordinary measures crammed into a period of less than a year (see, for example, Boettke 2008; Gonigam 2009; Lam 2009). With the Obama administration in the saddle, prospects appear favorable for a continuation of this kind of frantic policy activism. It cannot help, and it may hurt a great deal.

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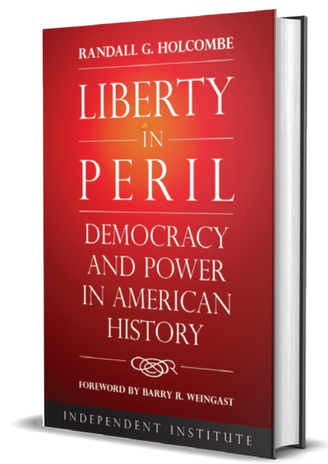

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