The Free Market

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TEN GREAT ECONOMIC MYTHS

Part I

by
Murray N. Rothbard

Our country is beset by a large number of economic myths that distort public thinking on important problems and lead us to accept unsound and dangerous government policies. Here are ten of the most dangerous of these myths and an analysis of what is wrong with them.

Myth #1

Deficits are the cause of inflation; deficits have nothing to do with inflation.

In recent decades we *always* have had federal deficits. The invariable response of the party *out* of power, whichever it may be, is to denounce those deficits as being the cause of our chronic inflation. And the invariable response of whatever party is *in* power has been to claim that deficits have nothing to do with inflation. *Both* opposing statements are myths.

Deficits mean that the federal government is spending more than it is taking in in taxes. Those deficits can be financed in two ways. If they are financed by selling Treasury bonds to the public, then the deficits are not inflationary. No new money is created; people and institutions simply draw down their bank deposits to pay for the bonds, and the Treasury spends that money. Money has simply been transferred from the public to the Treasury, and then the money is spent on other members of the public.

On the other hand, the deficit may be financed by selling bonds to the banking system. If that occurs, the banks create *new* money by creating new bank deposits and using them to buy the bonds. The new money, in the form of bank deposits, is then spent by the Treasury, and thereby enters permanently into the spending stream of the economy, raising prices and causing inflation. By a complex process, the Federal Reserve enables the banks to create the new money by generating bank reserves of one-tenth that

Professor Murray Rothbard and Director Lew Rockwell at the Mises Institute's Gold Standard Conference.

amount. Thus, if banks are to buy $100 billion of new bonds to finance the deficit, the Fed buys approximately $10 billion of *old* Treasury bonds. This purchase increases bank reserves by $10 billion, allowing the banks to pyramid the creation of new bank deposits or money by ten times that amount. In short, the government and the banking system it controls in effect "print" new money to pay for the federal deficit.

Thus, deficits are inflationary to the extent that they are financed by the banking system; they are *not* inflationary to the extent they are underwritten by the public.

Some policymakers point to the 1982-83 period, when deficits were accelerating and inflation was abating, as a statistical "proof" that deficits and inflation have no relation to each other. This is no proof at all. General price changes are determined by two factors: the supply of, and the demand for, money. During 1982-83 the Fed created new money at a very high rate, approximately at 15 percent per annum. Much of this went to finance the expanding deficit. But on the other hand, the severe depression of those two

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those two years increased the demand for money (i.e. lowered the desire to spend money on goods), in response to the severe business losses. This temporarily compensating increase in the demand for money does not make deficits any the less inflationary. In fact, as recovery proceeds, spending will pick up and the demand for money will fall, and the spending of the new money will accelerate inflation.

Myth #2

Deficits do not have a crowding-out effect on private investment.

In recent years there has been an understandable worry over the low rate of saving and investment in the United States. One worry is that the enormous federal deficits will divert savings to unproductive government spending and thereby crowd out productive investment, generating ever-greater long-run problems in advancing or even maintaining the living standards of the public.

Administration spokesmen have once again attempted to rebut this charge by statistics. In 1982-83, they declare, deficits were high and increasing, while interest rates fell, thereby indicating that deficits have no crowding-out effect.

This argument once again shows the fallacy of trying to refute logic with statistics. Interest rates fell because of the drop of business borrowing in a recession. "Real" interest rates (interest rates minus the inflation rate) stayed unprecedentedly high, however — partly because most of us expect renewed heavy inflation, partly because of the crowding-out effect. In any case, statistics cannot refute logic; and logic tells us that if savings go into government bonds, there will necessarily be less savings available for productive investment *than there would have been*, and interest rates will be higher than they would have been without the deficits. If deficits are financed by the public, then this diversion of savings into government projects is direct and palpable. If the deficits are financed by bank inflation, then the diversion is indirect, the crowding-out now taking place by the new money "printed" by the government competing for resources with old money saved by the public.

Milton Friedman tries to rebut the crowding-out effect of deficits by claiming that *all* government spending, not just deficits, equally crowds out private savings and investment. It is true that money siphoned off by taxes could also have gone into private savings and investment. But deficits have a far greater crowding-out effect than overall spending, since deficits financed by the public obviously tap savings and savings alone, whereas taxes reduce the public's consumption as well as savings.

Thus, deficits, whichever way you look at them, cause grave economic problems. If they are financed by the banking system, they are inflationary. But even if they are financed by the public, they will still cause severe crowding-out effects, diverting much-needed savings from productive private investment to wasteful government projects. And, furthermore, the greater the deficits the greater the permanent income tax burden on the American people to pay for the mounting interest payments, a problem aggravated by the high interest rates brought about by inflationary deficits.

Myth #3

Tax increases are a cure for deficits.

Those people who are properly worried about the deficit unfortunately offer an unacceptable solution: increasing taxes. Curing deficits by raising taxes is equivalent to curing someone's bronchitis by shooting him. The "cure" is far worse than the disease.

For one reason, as many critics have pointed out, raising taxes simply gives the government more money, and so the politicians and bureaucrats are likely to react by rais[illegible] expenditures still further. Parkinson said it all in his famous "Law": "Expenditures rise to meet income." If the government is willing to have, say, a 20 percent deficit, it will handle high revenues by raising spending still more to maintain the same proportion of deficit.

But even apart from this shrewd judgment in political psychology, why should anyone believe that a *tax* is better than a higher price? It is true that inflation is a form of taxation, in which the government and other early receivers of new money are able to expropriate the members of the public whose income rises later in the process of inflation. But, at least with inflation, people are still reaping some of the benefits of exchange. If bread rises to $10 a loaf, this is unfortunate, but *at least* you can still eat the bread. But if taxes go up, your money is expropriated for the benefit of politicians and bureaucrats, and you are left with no service or benefit. The only result is that the producers' money is confiscated for the benefit of a bureaucracy that adds insult to injury by using part of that confiscated money to push the public around.

No, the only sound cure for deficits is a simple but virtually unmentioned one: cut the federal budget. How and where? Anywhere and everywhere.

Myth #4

Every time the Fed tightens the money supply, interest rates rise (or fall); every time the Fed expands the money supply, interest rates rise (or fall).

The financial press now knows enough economics to watch weekly money supply figures like hawks; but they inevitably interpret these figures in a chaotic fashion. If the money supply rises, this is interpreted as lowering interest rates and inflationary; it is *also* interpreted, often in the very same article, as raising interest rates. And vice versa. If the Fed tightens the growth of money, it is interpreted as both raising interest rates and lowering them. Sometimes it seems that *all* Fed actions, no matter how contradictory, must result in raising interest rates. Clearly something is very wrong here.

The problem here is that, as in the case of price levels, there are several causal factors operating on interest rates and in different directions. If the Fed expands the money supply, it does so by generating more bank reserves and thereby expanding the supply of bank credit and bank deposits. The expansion of credit necessarily means an increased supply in the credit market and hence a lowering of the price of credit, or the rate of interest. On the other hand, if the Fed restricts the supply of credit and the growth of the money supply, this means that the supply in the credit market declines, and this should mean a rise in interest rates.

And this is precisely what happens in the first decade or two of chronic inflation. Fed expansion lowers interest rates; Fed tightening raises them. But after this period, the public and the market begin to catch on to what is happening. They begin to realize that inflation is chronic because of the systemic expansion of the money supply. When they realize this fact of life, they will also realize that inflation wipes out the creditor for the benefit of the debtor. Thus, if someone grants a loan at 5% for one year, and there is 7% inflation for that year, the creditor loses, not gains. He loses 2%, since he gets paid back in dollars that are now worth 7% less in purchasing power. Correspondingly, the debtor gains by inflation. As creditors begin to catch on, they place an inflation premium on the interest rate, and debtors will be willing to pay. Hence, in the long-run anything which fuels the expectations of inflation will raise inflation premiums on interest rates; and anything which dampens those expectations will lower those premiums. Therefore, a Fed tightening will now tend to dampen inflationary expectations and *lower* interest rates; a Fed expansion will whip up those expectations again and *raise* them. There are two, opposite causal chains at work. And so Fed expansion or contraction can either raise or lower interest rates, depending on which causal chain is stronger.

Which will be stronger? There is no way to know for sure. In the early decades of inflation, there is no inflation premium; in the later decades, such as we are now in, there is. The relative strength and reaction times depend on the subjective expectations of the public, and these cannot be forecast with certainty. And this is one reason why economic forecasts can never be made with certainty.

Myth #5

Economists, using charts or high speed computer models, can accurately forecast the future.

The problem of forecasting interest rates illustrates the pitfalls of forecasting in general. People are contrary cusses whose behavior, thank goodness, cannot be forecast precisely in advance. Their values, ideas, expectations, and knowledge change all the time, and change in an unpredictable manner. What economist, for example, could have forecast (or *did* forecast) the Cabbage Patch Kid craze of the Christmas season of 1983? Every economic quantity, every price, purchase, or income figure is the embodiment of thousands, even millions, of unpredictable choices by individuals.

Many studies, formal and informal, have been made of the record of forecasting by economists, and it has been consistently abysmal. Forecasters often complain that they can do well enough as long as current trends continue; what they have difficulty in doing is catching *changes* in trend. But of course there is no trick in extrapolating current trends into the near future. You don't need sophisticated computer models for *that*; you can do it better and far more cheaply by using a ruler. The real trick is precisely to forecast when and how trends will change, and forecasters have been notoriously bad at that. No economist forecast the depth of the 1981-82 depression, and none predicted the strength of the 1983 boom.

The next time you are swayed by the jargon or seeming expertise of the economic forecaster, ask yourself this question: If he can really predict the future so well, *why* is he wasting his time putting out newsletters or doing consulting when he himself could be making trillions of dollars in the stock and commodity markets?

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Professor Rothbard's article will be continued in the next issue of **The Free Market.**

Murray N. Rothbard is professor of economics at the Polytechnic Institute of New York. He received his B.A., M.A. and Ph.D. in economics from Columbia University, and he studied under Ludwig von Mises at New York University.

The author of many important works in Austrian economics — such as *America's Great Depression, Power and Market, The Panic of 1819,* and *Man, Economy, and State* — Dr. Rothbard is also editor of the Mises Institute's scholarly journal of Austrian economics, serves as a member of the Institute's distinguished Board of Visitors, and is the Institute's senior adjunct scholar.

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