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In response to Paul Krugman's "How Did Economists Get It So Wrong?" appearing in The New York Times Sept 6th, 2009 From An Austrian Perspective

"The whole history of civilization is strewn with creeds and institutions which were invaluable at first, and deadly afterwards."
Walter Bagehot

"It is contagion that determines the fate of a theory in social science, not its validity."
Nassim Taleb

Mr. Krugman's "op-ed" piece is most impressive indeed, yet surprising in two aspects. First, it seems odd that Mr. Krugman points to other economists as getting "it" wrong while falling to acknowledge that he too has gotten it wrong on many occasions. Referencing Krugman's prior work, economist Marc Faber states that it would have been more appropriate to title the article "How Did I, Paul Krugman, Among Other Economist Get It So Wrong?" Second, in his piece the author examines the crisis relying only on two Schools of economic thought: Neoclassical and Keynesian – creating an illusion that there is not a worthy alternative. A third school of thought in large omitted[1] by the author that warrants a discussion is the Austrian School of Economics. The purpose of this article is to examine Dr. Krugman's assumptions, examples, and resulting conclusions, while taking an Austrian economics approach.

To understand the fundamentals of Austrian approach, it is productive to start with one of the best quick overviews on Austrian school that was written by Sean Corrigan in his article "To Be an Austrian – A Primer." He illuminates it this way: "Each man's individual motivation ( ) is wholly different to that of his neighbour's and it is an ordinal one—with little scope for quantitative measurement and certainly none for aggregation. ( ) Value is a specific, not a generic, quality and varies according to time, place, and circumstance. ( ) Choices are made "at the margin." ( ), i.e. a process where person makes an exchange only after making a subjective mental comparison of the cost of forgoing the most willingly surrendered (the most "marginal") tradable quantum of his existing property with the benefit he expects to enjoy from the corresponding, first quantum of goods offered for it by his counterparty, as well as with those which might accrue from trading for another's, different, goods instead. ( ) These insights are said to be made *a priori* and Austrian reasoning is thus deductive, not inductive, or empirical. Economics is, then, evidently a discipline where mathematical abstraction can play little part."

In that article, Mr. Corrigan unveiled a panorama of contributions by Austrian economists. Von Mises is most known for advocating for private property and an unhindered price mechanism. His most comprehensive "Theory of Money and Credit" irrefutably showed that inflation and credit expansion are always at the forth front of the crises and at the end lead to mal-investment (misdirected sub-marginal investment) and bottlenecks. That theory gave birth to Austrian

[1] Mr. Krugman does mention Joseph Schumpeter, but only in one, rather belittling, sentence.

Theory of Business Cycle, which discussed in detail how an inflationary infusion distorts price signals—particularly inter-temporal ones. Together with Rothbard he campaigned for a system based on 100% commodity reserve, free-banking, meaning no FDIC, no Fed, no fiat, no fractional reserves. Hayek joined Mises in showing that "there can be no room for compromise, that a "mixed" economy inevitably leads to an erosion of freedom and the growth of the state to the detriment of all those not in the "ruling classes." Menger and Boehm-Bawerk derived the most satisfying theory of the origins of interest—the so-called natural rate being, essentially, a measure of mortal man's inherent impatience with any delay in the gratification of his wants and needs. Hazlitt insisted that "there is no such thing as a free lunch and that we must always look beyond the immediate results of an action to see its hidden and indirect influences before we pronounce it a success or a failure." Mr. Corrigan concluded: "Austrian theory is thus dynamic, not static; logical, not empirical; deductive, not inductive; individualistic, not aggregative; libertarian, not statist; it does not confuse money with wealth; it knows that production delivers prosperity, not consumption; […] it demands the minimum possible intrusion upon private property and personal liberty. It places prime importance on the capital structure of the economy, apotheosizes the entrepreneur, despairs of government and utterly disdains Marxists, Keynesians, Chicagoites, and all other Historicists and pseudo-Natural Scientists."

With this perspective in mind Mr. Krugman's article is analyzed.

"**During the golden years, financial economists came to believe that markets were inherently stable – indeed, that stocks and other assets were always priced just right."** The author's reprimanding tone against such economists is transparent. Mr. Krugman mentions there were "few" had seen the collapse coming, but the only name mentioned in the article is Mr. Schiller's. In the meantime, there were in fact a number of modern economists that not only foresaw the problems early, but even predicted in detail how they would unveil: Marc Faber, Jim Rogers, Lew Rockwell, Hunter Lewis, Nassim Taleb, Peter Schiff, Roger Garrison, and many others. Austrian economists from a century earlier too foretold of issues to come, such economists were: Ludwig Von Mises, Frederick Hayek, Henry Hazlitt, Joseph Schumpeter, Carl Menger, Eugen Von Boehm-Bawerk, and more. What does seem as an interesting fact is that Mr. Krugman does not have his own precedence of having the foresight on many of the issues that he so elegantly addresses in hindsight.

"**But the main division was between those who insisted that free-market economies never go astray and those who believed that economies may stray now and then but that any major deviations from the path of prosperity could and would be corrected by the all-powerful Fed**" In lieu of Mr. Krugman's disinclination to include Austrians, who subscribed to neither notion, but succeeded in foreseeing the crisis, it is important to inspect what particularly does Mr. Krugman find problematic with the above notions in light of the Austrian thought. The first part that free markets don't go astray, of course, is just simply unrealistic, so there is no disagreement with the author's irony. However, provided that the author still means free market economies in the second part of this sentence, where he writes that if economies do go astray then the Fed would correct it, the author is inconspicuously coalesces incompatible concepts – these economies cannot have an assumption of a free market, since there cannot be such institution as "all powerful Fed" in a free market economy. It is essential to elucidate this egregious flaw since it is weaved into the rhetoric of the entire article, thus falsely insinuating incompetency of the free markets. This consensus builds momentum a few lines later: "**Until the**

Great Depression, most economists clung to a vision of capitalism as a perfect or nearly perfect system. That vision wasn't sustainable in the face of mass unemployment […]"
Since true capitalism is impossible with such entity as Federal Reserve or any other form of a Central Bank, Austrian economists find it behooving to examine the practices of the latter.
"**Neither side was prepared to cope with an economy that went off the rails**. **As I see it, the economics profession went astray because economists, as a group, mistook beauty, clad in impressive-looking mathematics, for truth.**" Author's sarcasm is certainly appropriate; unfortunately, it conceals a more central problem that is two-fold.
First, from the stand of point of mathematics, a model can only be as good as the data supplied to it. Some of the vital data supplied by BLS is fundamentally flawed. For instance, the use of geometric distribution in the CPI metric allowed the statisticians to readjust the item's weight retrospectively resulting in fallible statistics. Furthermore, the often cited Core CPI does not include food and energy prices, yet those are imperative to any analysis. The unemployment figures do not include discouraged and underemployed individuals, for the exception of U6 metric, which is usually overlooked. However, even U6 metric is inaccurate since BLS recently adopted a new Death/Birth [of a business cycle] model creating fictitious jobs in the data.
Second and most important issue is that the true folly of economists was mistaking a lopsided hybrid monster created by government interventions, such as artificially low rates, excessive credit growth, and leverage under government guarantees, for free market capitalism. Austrian economists evinced that it is the latter three that are true emissaries of destruction that bring the inevitable collapse. Therefore, blaming mathematics in the tragedy is as absurd as convicting a gun in a homicide – it is merely an instrument.
"They turned a blind eye to the limitations of human rationality that often lead to bubbles and busts;" While Mr. Krugman delineates a chaste governmental complicity, a thorough examination of antecedents and concomitant conditions points to the evidence that "they" are the main culprits that engendered irrationality in the first place. Austrian economists understand that rationality (or preferences) does not exist in vacuum, but rather grounds on a belief system, which in turn is propagated by actions, i.e. actions of institutions such as Federal Reserve and other various governmental agencies. Under the clout of such institutions human rationality is often induced into brazen delirium. Modern Austrian economist, Roger Garrison pointed out: "an extra-market force (the central bank) can initiate an artificial or unsustainable economic boom. The money induced boom contains the seeds of its own undoing: the upturn, by the logic of market forces set in motion, will be followed by a downturn." Von Misses and Hayek have argued tirelessly that monetary expansion engenders a boom, which eventually leads to a bust. In contrast to Mr. Krugman's explanation, Von Mises unveiled specifically the anatomy of the boom/bust cycle: "the recurrence of periods of boom, which are followed by periods of depression, is the unavoidable outcome of the attempts, repeated again and again, to lower the gross market rate of interest by means of credit expansion. There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved."
Economists Keneth Roggoff and Carmen Reinhart in their brilliant paper "This Time Is Different" conducted an empirical study based on a comprehensive new statistical dataset that covers every region of the world and spans up to eight centuries concluding that inflation, debt and default are integrally related and have gone hand-in-hand. (Reinhart, Rogoff, 2008)

"He [Keynes] wanted to fix capitalism, not replace it. He wanted to fix capitalism, not replace it. But he did challenge the notion that free-market economies can function without a minder, expressing particular contempt for financial markets, which he viewed as being dominated by short-term speculation with little regard for fundamentals. And he called for active government intervention — printing more money and, if necessary, spending heavily on public works — to fight unemployment during slumps." It is disconsolate to encounter yet another round of awry Keynesian logic. If Keynes viewed financial markets being dominated by short-term speculation with little regard for fundamentals, it is thus illogical that he advocated printing money out of thin air since that cheap money would find their way right into the very hands of the speculators. Since printed money debase currency in circulation, which in turn lowers real interest rate [amidst increased inflation], and low interest rates fuel the very speculation that the author finds problematic a line earlier. For instance, federal fund rate cuts from 2001 to 2002 and then from 2008 to 2009 coincides with the highest levels of speculative intensity. (Fig. 1)

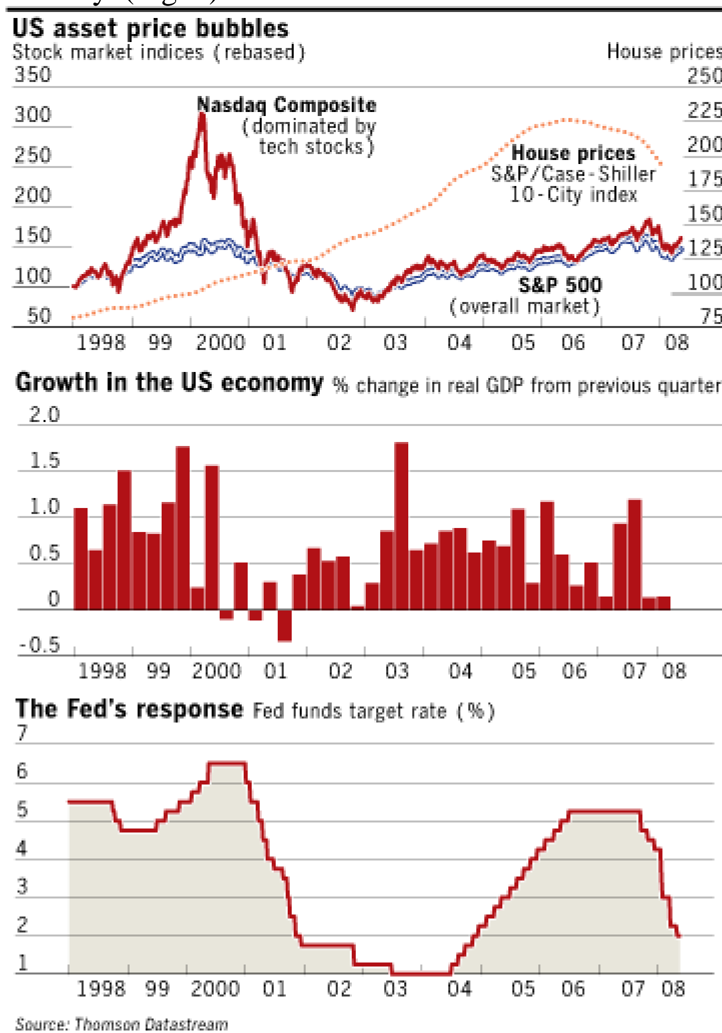

Figure 1

Von Misses demonstrating how intervention causes destabilization of the business cycle insisted: "There is no use in interfering by means of a new credit expansion with the process of

readjustment. This would at best only interrupt, disturb, and prolong the curative process of the depression, if not bring about a new boom with all its inevitable consequences."

"**And Keynes considered it a very bad idea to let such markets, in which speculators spent their time chasing one another's tails, dictate important business decisions: "When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.**"" Brilliantly said, but the brunt of his idea disconcerts his own logic of interventionist policies. What Krugman fails to acknowledge is that absent government guarantees, safety nets, bail outs, and excessive credit provision, the time that speculators would get a chance to act irresponsibly would be quite limited since they would go bankrupt amidst illiquidity. Consequent liquidation gives way to more competent companies which in turn benefit from the diminished pool of competition. Austrian economists demonstrated that in case of asymmetric incentive structure, i.e. if the market knows it is to be supported by a lender of last resort, it will feel less to no responsibility for the effective functioning of money and capital markets during the next boom. They understood that such asymmetry in risk/reward configuration encourages brisk re- and over-leveraging. Sean Corrigan elaborated that the public good of the lender of last resort weakens the private responsibility of "sound" banking.
It turns out that the concept of casino is central here. Casino is where players either are oblivious to the risks or don't care about loses. The evidence points to government and its subsidized/guaranteed entities being guilty of both. Therefore, the casino is the government itself.
"**And the world's possibilities of wealth did indeed run to waste for a long time: it took World War II to bring the Great Depression to a definite end.**" With all due respect to Mr. Krugman, we got out of the Depression not because of the war, but despite of it. Economist Irving Fisher, in his book "Booms and Depressions" in 1932, correctly identified "over-indebtness" as a leading culprit for the Depression. He pointed out that debts were out-of-line and too big relative to other economic factors. Therefore, what brought the end of Depression was private economy productivity[2] and savings. Economist Marc Faber agrees that "the depression was only a consequence of the previous speculative credit-driven boom that led to the excesses of the 1920s, which many economists often ignore."
If it took wars to bring countries out of crises then Soviet Union would still be around and prospering while Somalia, Sri-Lanka, Iraq and a few other "hot" spots around the world would be experiencing economic booms! This eerie logic has been successfully debunked by Hazlitt's famous argument of a "broken window" analogy.

"**Keynesian demand-side view of recessions with neoclassical theory, they found the evidence that recession are in fact demand driven too compelling to reject…**" It is imperative to point out that a true and sustainable demand is not driven by government, confidence, abundance of money, a good will, or even relatively low prices, but a product - so unique, efficient, effective, and productive, with the capacity to provide the <u>additional</u> value to its user. Such prospect is achieved either by lowering current expenditures or generating more revenue for the same working time. After the first period the user is able to not only pay the cost of the product, but also keep the remainder of revenue as profit. This way the buyer is always incentivized to obtain the product as soon as possible. In any other case consumer would

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[2] The author went into detail how industrial and manufacturing booms took place as a consequence of a quick retooling of the tank, riffle, and bullet factories into manufacturing facilities of consumer goods.

postpone the purchase. It is not so much the price that encourages a person to buy a product, but rather additional value in productivity that it can generate.
Therefore, it is easy to see how productive capacity of a consumer good constitutes its demand even in a deflationary environment. This in turn ensures most efficient resource allocation, economic growth, and progress of humanity as Austrians vigilantly advocate for. In fact, Marc Faber along with many economists of Austrian economic views agreed that "the entire economic expansion of the US in the 19th century was a deflationary boom. Manufacturing and industrial sectors were expanding rapidly delivering more of new productive and competitive consumer goods. Declining prices led to strong real income gains along with population growth. As time went by, workers could buy with their incomes a larger and larger basket of goods because prices for consumer goods and commodities declined. The country prospered."

"**How did they miss the bubble?" To be fair, interest rates were unusually low, possibly explaining part of the price rise. ( ) There was something else going on: a general belief that bubbles just don't happen. ( ) In short, the belief in efficient financial markets blineded many if not most economists to the emergence of the biggest financial bubble in history. And efficient-market theory also played a significant role in inflating that bubble in the first place."** If this assessment is intended to be a culmination of the article, it turns out to be a yet another disappointment. The author finally mentions low interest rates, but fails to concatenate it to the fact that it played a destabilizing element in the business cycle. He elicits that cultivation of the crisis on the belief in efficient financial markets. While this belief may have contributed it was certainly not its cause. Krugman fails to bring into focus the crux of the problem such as excessive credit growth, consequent leverage, and resulting mounts of debt (all are complements of Epicurean Federal Reserve and government guarantees). Figure 2 captures excessive credit growth from 7% to north of 16% from the year 2004 to 2009. Figure 3 demonstrates Debt to GDP ratio has grown from 130% in 1980 to 360% today which still excludes 59 Billions of unfunded liabilities of Medicare and medicate.

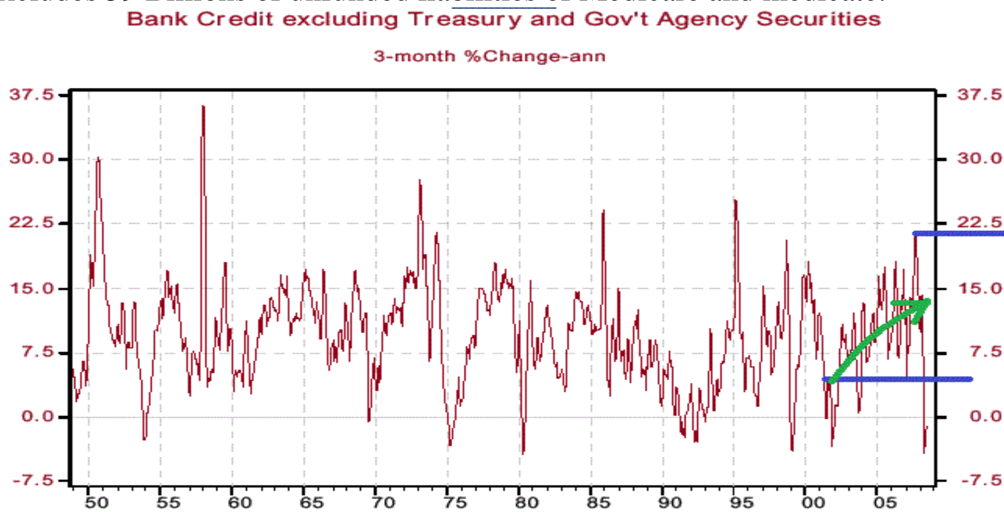

Figure 2[3] (Graph by Paul L Kasriel)

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[3] "Is the United States In Recession?" Sep 16, 2008
Paul L Kasriel

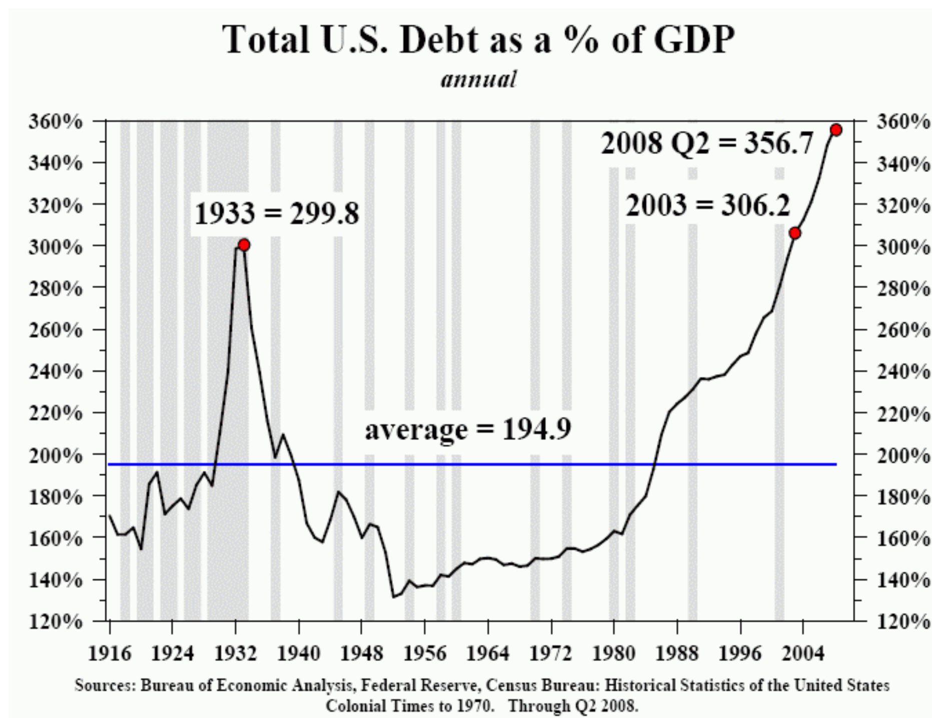

Figure 3

It is befuddling that Mr. Krugman never acknowledges that there is a clear link between governmental actions and irrational behavior. Bob Hoye once said: "When the Fed is the bartender, everyone drinks until they fall down." Peter Schiff extended it into a more vivid analogy that not only the Fed, like a bartender, got everybody liquored up, but it also provided the drunks with the car keys while helping them into the vehicle.
"**This will translate into more cautious policy advice – and a reduced willingness to dismantle economic safeguards in the faith that markets will solve all the problems.**" The true issue is that while market discipline does solve problems, it does not do so painlessly and certainly not instantaneously. What free markets do accomplish is to contain the scale of the crisis to relatively small proportions, consequently preventing a systemic collapse. In lieu of the earlier alcohol analogy, an interesting question need be considered: if an economist such as Mr. Krugman himself argues that people are irrational just a of couple lines earlier why would he still be excusing governmental "booze"? Maybe while blaming others for having "a blind eye" to the understanding of consequences of drinking and driving, Mr. Krugman could have developed "a blind eye" to the wrongfulness and illegality of the "alcohol provision." Von Mises understood it clearly: "It is beyond doubt that credit expansion is one of the primary issues of interventionism."

"**A sever plunge in asset prices, even if it makes no sense in terms of fundamentals, tends to deplete that capital. As a result, the smart money is forced out of the market and prices may go into a downward spiral.**" The author continues to argue that a bandage will fix the broken arm, but the answer can be found in Ludwig Von Misses' work: "There is no means of avoiding a final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as a result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved." In other

words the severity of the plunge in prices is directly proportional to the preceding leverage and debt, which are complements of preceding low rates.
This brings up his further comment: "**One line of work, pioneered by none other than Ben Bernanke working with Mark Gertler of New York University, emphasized the way the lack of sufficient collateral can hinder the ability of businesses to raise funds and pursue investment opportunities.**" Though Krugman is clearly sympathetic to this view, in reality it is an apotheosis of a round-trip fallacy mistake. The lack of sufficient collateral is indicative of the firm's already over leveraged condition. Providing additional (artificial) collateral will actuate further re-leveraging, and worse - will magnify it to an ever larger scale. In the end such continuously unregenerate practices bring about a systemic collapse, which Mr. Krugman is concerned about just a few paragraphs above. This inconsistency is crucial to understand. Keneth Roggoff of Harvard, in response to to Mr. Stiglitz, wrote the following: "Governments typically come to the IMF for financial assistance when they are having trouble finding buyers for their debt and when the value of their money is falling. The Stiglitzian prescription is to raise the profile of fiscal deficits, that is, to issue *more* debt and to print *more* money. You seem to believe that if a distressed government issues more currency, its citizens will suddenly think it more valuable. […] We at the IMF—no, make that we on the Planet Earth—have considerable experience suggesting otherwise. We earthlings have found that when a country in fiscal distress tries to escape by printing more money, inflation rises, often uncontrollably. Uncontrolled inflation strangles growth, hurting the entire populace but, especially the indigent. The laws of economics may be different in your part of the gamma quadrant, but around here we find that when an almost bankrupt government fails to credibly constrain the time profile of its fiscal deficits, things generally get worse instead of better."

At the end of his circumlocution, Mr. Krugman explains the necessity of integration and interconnection of disciplines like behavioral finance, Keynesian Economics, "the realities of finance", and macroeconomics, and serves this toxic cocktail as a remedy to the redemption of the Economic profession. Having successfully avoided the underpinning root cause of the disease, it is doubtful that any new "whirl wind" combination of fancy "bandages" will provide any relief. These cracked foundations are inept to provide solid footing to the longed redemption of the profession no matter how many times they will be patched up. In contrast, all along Austrian school of economics presents far superior economic theory that correctly identifies the origins of crisis found in reckless policies of government and Federal Reserve. Economists of this school have successfully predicted the details of the numerous crises that have plagued the world. Although such school of economics does not promise Recession-free world, Austrian principles are effective in shortening the time of downturns, diminishing the severity (scale) of its consequences bringing the bulk of it not upon the competent agents or general public, but upon the inefficient and leveraged players and the culprits of the disasters. In turn such liquidations prevent reoccurring asset bubbles, abysmal deficits, and the systemic collapses while making an economy robust to failures and incompetence. Such cleansing process of the market is vital for long term sustainability of the human progress as Austrians economists have shown time and again. In the future, if the profession of economists intends to redeem itself, such efforts will be futile without incorporating Austrian school of economics at the foundations of analyses.

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