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Presentation  
to  
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by  
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## The War of Economic Theories

The lopsided war between the Keynesian and the Austrian schools of economic theory is very relevant to our social and political futures.

## Fundamental Difference

The fundamental difference between the Keynesian theories and the Austrian theories centers on the power of government:

Keynesians believe the government can effectively control, manage, and otherwise manipulate the economy.

Austrians believe that the economy is like gravity: it has its own natural force that must be accommodated.

## Keynesian School

The Keynesian school of economics was founded by John Maynard Keynes, a British economist. Keynes published *The General Theory of Employment, Interest and Money* in 1936.

From the Wikipedia article on “Keynesian Economics”:

“Keynes argued that government policies could be used to increase aggregate demand, thus increasing economic activity and reducing high unemployment and deflation. Keynes’s macroeconomic theories were a response to mass unemployment in 1920s Britain and in 1930s America.”

“Keynes argued that the solution to depression was to stimulate the economy ... through some combination of two approaches: a reduction in interest rates and government investment in infrastructure”

## Austrian School

The Austrian school of economics was founded by Carl Menger in Vienna in 1871 and was continued by Ludwig von Mises and Friedrich von Hayek in the 20<sup>th</sup> Century.

From the Wikipedia article on “Austrian School”:

“The Austrian economists were amongst the first to clash directly with Marxism, since both dealt with such subjects as money, capital, business cycles, and economic processes.”

“Austrians view entrepreneurship as the driving force in economic development, see private property as essential to the efficient use of resources, and usually (if not always) see government interference in market processes as counterproductive.”

## Business Cycle Theory

A very relevant difference between the Keynesians and the Austrians is in their views of the observed business cycles of boom and bust.

The Austrian Theory:

- Deceit
- Malinvestment
- Bubble
- Discovery
- Crash
- Readjustment
- Recovery

The Keynesian Theory:

- Market Failure
- Bubble
- Discovery
- Crash
- Government Intervention
- Recovery

Keynesian’s don’t acknowledge the concept of malinvestment, yet the concept is vital to an understanding of economic booms and crashes.

Here is a story to illustrate the concept of malinvestment:

## Thousands of Monkeys

One day a luxury car and a truck carrying a huge empty cage drove into a remote village in India.

A man in a business suit emerged from the luxury car and announced that he was from New York and needed to purchase some moneys. He would pay \$10 for each monkey brought to the truck cage.

The young men of the village were electrified. They abandoned their farm work and hunted moneys in the surrounding jungles. Hundreds of monkeys were brought in and hundreds of ten-dollar bills disappeared into hiding holes. Finally the young men went back to their farm work.

Then the man from New York announced that he would now pay \$15 for each monkey brought to the truck cage.

The young men dropped their work and ran to the jungles again to gather as many monkeys as possible. They sold moneys to the man for \$15 each. Then, they finally went back to work in the fields.

Then the man from New York announced that he would pay \$20 for each monkey brought to the truck cage.

The whole village dropped everything and ran to the jungle to gather more monkeys. Each villager joyfully accepted a crisp \$20 bill in exchange for a screaming monkey in a bag. Many repeated this several times. Then they all went back to work.

The man from New York had to go to a business meeting in New Delhi, but he promised that when he returned, he would buy monkeys for \$50 each. The villagers talked about nothing else.

Meanwhile, word got around that the businessman's assistant wanted to help the villagers. He would sell all the monkeys in the truck for \$35 each and would then gather a new load of monkeys to replace these in the next village. The villagers could then resell the same monkeys to the man from New York at a \$15 profit per monkey.

Gradually, but inevitably, the village went wild with the golden opportunity. Money was pulled from every savings place to pay for investment monkeys.

The assistant drove off to the next village with an empty truck.

The man from New York never returned.

## Malinvestment Follows Deceit

Malinvestment is not just a bad investment. Malinvestment follows and is a consequence of deceit and withheld or falsified information.

Any investment scheme relying on deceived investors yields malinvestment.

## Sudden Discovery

Why do business cycles always involve a sudden discovery and a crash?

It is because the value of malinvestment is inflated by deceit and the true (low or zero) value of the malinvestment is discovered suddenly when the deceit is revealed.

In the case of Thousands of Monkeys in the remote village in India, the crash did come with some sudden discovery. Monkeys might have been kept in makeshift cages in homes for weeks and months while the whole village talked about the imminent return of the man from New York.

Some trading will even occur for a time at the inflated price. A widow needing cash will sell her monkeys for just \$45 each while the buyer tracks his \$5 "profit", and may even spend it ahead of time.

But one day some old geezer will dump his monkeys for \$30 each and will afterwards bitterly complain that the man from New York is a crook and will never return to the village.

This will cause panic selling and a crash in the value of caged monkeys. Finally, the biggest monkey entrepreneurs, the dumb guys with thousands of cheap monkeys, will free all their caged monkeys and will hunt for honest work. The crash takes place immediately after the sudden general discovery of the deceit.

## The Deceit of Created Money

The central deceit in every national economy is the deceit of created money.

Let's look at just one aspect of this: fractional reserve banking.

Imagine an isolated western town with a single bank. Imagine that the bank is started when all of the townspeople deposit their dollar bills into bank accounts. So, when the bank first opens, it has \$100,000 in paper money in its vault and townspeople have \$100,000 in their bank checking accounts.

The official reserve requirement is 10%. Fractional reserve banking means the bank is required to keep a fraction of the total of checking account balances on reserve in the form of paper money in the vault.

So the bank loans 90% or \$90,000 to town entrepreneurs at interest.

Those entrepreneurs deposit the borrowed money in new checking accounts.

The bank now has a balance sheet that says:

Paper money in the vault	\$100,000
Owed to the bank	90,000
Checking balances owed to customers	\$190,000

As the bank is only required to keep 10% reserves, it is able to loan out another \$171,000 at interest.

It loans another \$171,000 to bright young town entrepreneurs yielding a new balance sheet which reads:

Paper money in the vault	\$100,000
Owed to the bank	260,000
Checking balances owed to customers	\$360,000

The bank is still quite solvent and not at all in trouble with bank regulators because it has over 27% in reserves when it is only required to have 10% in reserves!

Meanwhile, the money is circulating madly in the town. Someone buys something from the store with a check and the check is deposited into the bank by the store owner. There is nothing really static here, the money is circulating around with great rapidity.

The bank is collecting interest on \$260,000 and is participating in the town's incredible prosperity.

But there is a condition of deceit. And there are resulting malinvestments.

The deceit is the false appearance that the town has a money supply of \$360,000. That is the total of all checking accounts. That is the town's money supply.

But 72% of the money supply is new money created out of thin air due to a deceit by the bank.

And the malinvestment is obvious if you observe the town. The entrepreneurs are investing in wild schemes. The former town bum is now the PR agent for a new DOT-COM adventure. High living has increased. Land values are higher.

## Sudden Discovery Again

Sudden discovery can hit at any time and from any direction. In our example of the isolated western town, it could be precipitated by something as simple as a respected rancher retiring to Florida.

The old rancher and his wife put the ranch up for sale. Another young entrepreneur wants to buy it. He goes to the bank for a new loan.

The banker sees that he is nowhere near his limit (the 10% reserve requirement), so he gladly loans \$85,000 to the bright young would-be rancher. The full amount of the loan is deposited into a new bank account for the young entrepreneur. Now the bank's balance sheet reads as follows:

Paper money in the vault	\$100,000
Owed to the bank	345,000
Checking balances owed to customers	\$445,000

The banker has 22 ½ % held as reserves! Very comfortable. Way above the required 10%. He is a conservative banker.

But when the retiring rancher and his wife come into the bank, rather than depositing the \$80,000 check used to buy the ranch, he wants to cash the check. And he would also like to have his own \$15,000 checking account closed so he can have that additional cash to take with him to Florida.

What does the banker do? He had better not deny the respected rancher his money. The banker suddenly feels guilty as if he has done something wrong. The crash starts right here.

But to perpetuate the deceit, the banker gives the rancher and his wife the requested \$95,000 in cash. They happily take the cash and begin their trip to a lovely new home in Florida.

Nursing a bottle of whiskey, the banker studies his new balance sheet all through the night:

Paper money in the vault	\$ 5,000
Owed to the bank	345,000
Checking balances owed to customers	\$350,000

His reserves are now only 1.43%. This is way less than the 10% reserve requirement. He doesn't dare tell the Mayor, or the Bank Examiner at the state capitol. He can't even tell his own wife.

He had better call in some of these loans and get some more cash in the vault.

As they say, the rest is history.

The town has an economic crash. There is a run on the bank. The banker barely leaves town before a lynch mob is organized. And the formerly-respected rancher, now in Florida, is blamed by many for all of the town's sudden unexpected poverty.

## Why Are There No Austrian Bankers?

So why are there no Austrian bankers? Why do banks only hire Keynesian economists?

Because bank manipulation of money is condoned and glorified by Keynesian theory. It is condemned by Austrian theory as a cause of deceit, malinvestment, and the creation of false booms followed by inevitable busts.

Money expansion by banks is glorified by Keynesians as a solution to recession. When there is a recession, Keynesians prescribe more money expansion to fix it.

When there is a discovery, a crash, and a recession, the Austrians point out that the whole thing was caused by the deceit of the money expansion in the first place.

## The Austrian Program

So what do Austrian economists recommend to stop huge boom and bust cycles in the economy?

Sound money with 100% reserve requirements in money warehouses.

Sound money is any commodity money created by the market. Warehouse receipts are valid as money substitutes, as long as they do represent money commodity physically stored in a guarded warehouse.

Money should not be created by or manipulated by governments. The temptation to deceive is too great.

The current US Dollar has lost 95% of its value since the Federal Reserve was established in 1913. The Federal Reserve has failed to protect the value of the dollar in the past and cannot be trusted to do so in the future.

Let's permit the market to use alternative commodity moneys. It is more important to preserve the economy than to preserve the whole crumbling structure of Federal Reserve deceptions.

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