Economic Sense and Nonsense

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Against Politics

Justice and Its Surroundings

Political Economy, Concisely

Political Philosophy, Clearly

Social Justice and the Indian Rope Trick

ANTHONY DE JASAY

Economic Sense and Nonsense

REFLECTIONS FROM EUROPE

2008–2012

Anthony de Jasay

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HARTMUT KLIEMT

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The cuneiform inscription that serves as our logo and
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It is taken from a clay document written about 2300 B.C.
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PREFACE

This volume, companion to *Social Justice and the Indian Rope Trick,* in my Collected Papers, contains sixty monthly essays written for my column in The Library of Economics and Liberty website of Liberty Fund over the years 2008 to 2012. Those five years were something of a shambles in most of the Western economies, and their intellectual climate was not really pleasant. My five dozen essays, grouped roughly by subject, are contending with this climate and seek to defend what I believe is valid economics and the liberal thought which such economics supports. It is odd that it should require a defense. Prior to 2007, it was the accepted orthodoxy, the Washington consensus of reasonably free markets, free trade, flexible exchange rates, and decreasing regulation. In the changed climate of the past five years, this orthodoxy has been partly or wholly rejected. Whose fault is it?

In our era of fast technological change, transport and communications technologies advance fastest of all. Modern transport technology brought us globalization by transforming a vast range of products that used to move only a few miles into tradeable goods moving with ease from one continent to another. This long-distance trade lifted a billion or so of the Asian poor out of abject misery and was mostly a good thing in other respects. The same is hardly true of communications technology. Ideas that used to move fairly slowly from place to place, being filtered and tested a bit on the way, now are perceived with the speed of light all over the world, where the internet and the so-called social networks hold sway. This is far from always being a good thing. It is the enabling condition of what I call, with unconcealed ill will, *parrot talk.* It is my chosen adversary in this book. It rises when some authority launches an idea, a departure from the old, which is easily plausible and responds to an anxiety or a need for putting the blame on some scapegoat for things not going as they should. The idea is picked up by the media and, deplorably enough, by the lesser lights in our universities and is repeated, parrotlike, until it becomes the generally accepted new orthodoxy.

The time of troubles had a small beginning. In mid-2007 it became common knowledge that about 400 billion dollars of so-called subprime American residential mortgages, sponsored by a "socially" inspired government and accepted by bankers of subprime intelligence, were in fact duds. It was close to nonsense to suppose that such a paltry sum, spread over a multitude of banks in the vast North Atlantic financial system, could not be digested without major upset. However, with no apparent reason for thinking that it would be helpful, two of the highest officials of the world monetary system then announced that the economy was about to crash into the worst depression since 1930. The parrot choir took up this self-fulfilling prophecy with almost hysterical shrillness. Interbank trust, indispensable for a fractional reserve system to function, was shaken, though often for no good reason.

As events passed by the corpse of Lehman Brothers and the comatose bodies of the Royal Bank of Scotland, AIG, and Citigroup, the regulators felt it a good idea to pour oil on the fire and to ratchet up the solvency ratios the banks had urgently to attain. These rules in Basel I, II, and III successively gave everyone to understand that the regulators again and again judged the solvency of the banks insufficient—surely the right way to cement mutual distrust and frighten off interbank lending. An equally unintended and even more damaging consequence was that under Basel III, the banks had to shrink their balance sheets and starve small businesses, dependent on the banks, of the credit they needed in overcoming the recession.

To appreciate the regulatory zeal, one may add that the American banking system was going to be put to rights by the 32,000 pages of the Dodd-Frank Act and its appendixes and by having two lawyers looking over the shoulder of every banker to see that what is being done is really legal. The ideal seemed to be to have a system consisting of cozy little Main Street banks as pictured in the *Saturday Evening Post* of bygone days.

Parrot talk now takes it as settled truth that prior to the troubles that have been besetting the economy since 2008, business was underregulated and was left too much to have its own way. Economic sense tells us that the system was and still is a hybrid one, neither fish nor fowl, and there is no quick and offhand way for telling whether regulating it any further would do better or worse. In the long run, most if not all regulation is a drag on the market and an obstacle to achieving the marginal equivalences at which factor allocation and consumer satisfaction are at their best.

In these essays, given the times when they were first offered to the reader, I could not nor did I want to avoid politics. One area where politics and economics merge is, of course, the sovereign debt. Electoral exigencies have always pushed democratic governments to spending money they did not have. As ill luck would have it, the rising burden of their debt relative to their GDP has reached the dangerous zone for many nations just at the wrong time, when they were also trying to cope with the upheaval in their banking system. For the eleven (later increased to seventeen) European states that in 1999 caught themselves in the trap of a common currency and deprived themselves of the use of a powerful and relatively painless means of adjustment, the flexible rate of exchange, the discomfort was doubly acute. For reasons which look rather like economic nonsense, it became the accepted wisdom that dissolution of the Eurozone would be an unspeakable catastrophe. Even the exit of one of the smallest and quite absurdly indebted member states, Greece, would threaten the survival of the whole zone. "Saving" Ireland and Portugal and Cyprus, but above all "saving" Greece became the subject of an almost daily television soap opera of these years. One school of thought would give the member states access to Germany's checkbook. Failing that, federalism must be promoted so that the budgets of the member states should be subjected to agreement in Brussels and, in case of excess, the guilty state should be subjected to sanction. Economic sense tells us loud and clear that the sanction would be a wagging finger and the sorrowful sigh of "naughty, naughty child."

Where parrot talk is really coming into its windy and woolly own is the ethics of the "system," which must be replaced by a "new model" that is both more rational, in better control of mercurial markets, and above all more devoted to human well-being than to selfish greed. There is today a near-unanimous condemnation of the very existence of a risk-ridden system. "Security" has come to be a supreme value in both halves of what this book calls Euramerica. "Security" has no price and must be pursued regardless of costs. Deliberately accepting risk is close to immoral; "speculation" is only a little less loathesome than child abuse. The condemnation of speculation and particularly of one of its techniques, short-selling, is a fascinating feature of the moral confusion and economic nonsense of our day. In fact, shaving off price peaks by selling and filling in price troughs by buying, which the speculator must do to succeed, is a contribution to the stability we are all supposed to desire, and it should be rewarded by a medal if not by a nice subsidy.

We should have learned from Adam Smith, if we did not know it already, that it is thanks to the selfish greed of "butcher, baker, and brewer"—and, yes, of banker—that we have our dinner on the table. It is an easily grasped theorem of economics that it is by firm striving to maximize the present value of profits that the best allocation of productive factors among alternative uses is approximated. It is truly frightening to think of what would happen if firms, listening to parrot talk, really tried to "meet human needs" instead of greedily maximizing profits. We are, thank heaven, in no imminent danger of this bizarre prospect.

Anthony de Jasay

PART 1

To Spend or Not to Spend?

1. TO SPEND OR NOT TO SPEND?

To spend or not to spend, that is the question that has lately faced many an economic Hamlet. There are pressing short-term reasons that say "spend" to alleviate the recession that has already begun or to avert the depression that many commentators profess to see looming on the horizon. There are longer-term reasons that do not all point the same way. Indeed, most would rather advise not to spend. Apart from the short vs. long term divide, there is divided counsel, too, about the proper role of government in the economy.

The immediate question for economic policy revolves around the fiscal stimulus, if any, that should be administered to offset the downward drag that is now manifest in every economy worth the name. Two things need first to be borne in mind.

First, the recession (in the best case) or slump (in the worst) is almost completely self-started. It has no "objective" cause such as an oil embargo or grave balance-of-payments trouble. Discounting the trigger effect of the subprime losses suffered by the banking system in 2007—at about $600 billion a fleabite to the world financial structure—the damage to our economies came from the snowballing loss of confidence by which everybody frightened everybody else to behave like wary hedgehogs.

The second preliminary that the makers of policy have to bear in mind is that 2008 has marked the end of the mentality of "buy now, pay later" that has characterised American, British, and to a lesser extent other societies. In the modern Anglo-American type of economy, it was the accepted thing to finance consumption by credit card and other debt, household saving hovered around zero as homeowners reckoned that the rising property market was doing their saving for them. The high-spending lifestyle is clearly going out of fashion and looks like it is being replaced by a more Teutonic culture of caution

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and thrift. Until very recently, using a credit card was considered by Germans as rather flashy and lightweight. It is now becoming just a bit daring everywhere else.

If household saving recovers and corporate investment is frightened off by all the talk about the coming "crisis," a gap opens up between capacity and demand, and it is this gap that public opinion urgently wants governments to fill by fiscal means. In Europe, the Maastricht rule of government deficits not exceeding 3 percent of GDP has been explicitly suspended. Had it not been, it would be violated regardless. Various stimulus "packages" have been announced and may well be increased in the coming year. The British package contains a large dose of reduced taxation on consumer expenditure and smaller doses of extra public spending, the whole amounting to nearly 4 percent of GDP. The public sector deficit will rise to over 8 percent in 2009. Smaller fiscal stimuli have been announced by most major European countries, the total amounting to about 1.5 percent of European GDP. Some of this is as yet vague and ill-defined, and the part to be devoted to public infrastructure investment can only be spent slowly as projects are approved and work gets going. (Europe's projected fiscal stimulus of 1.5 percent of GDP compares with the 2 percent of U.S. GDP that the Obama administration is thinking of spending on public infrastructure, though it could hardly do all or most of that within a twelve-month period.)

The European public spending plans would raise the budget deficits of the respective countries by between 1 and 5 percent of GDP. The British deficit would be brushing banana republic levels. Arguably, Britain can afford it, for its public debt is "only" 45 percent of its GDP. This compares with about 38 percent for the U.S.A. and Spain, 62 percent for Germany, 66 percent for France, and 104 percent for Italy.

It is on the level of the national debt that short- and long-term arguments about public spending clash against one another. It is plainly a waste to lose 300 billion euros of potential output in Europe (and a comparable sum in America) in a one-year recession, and if near-reckless public spending can avoid this, more glory to it. Contrary to eighteenth- and nineteenth-century beliefs that budget deficits are not only immoral but also practically impossible except sporadically, we now know that there is no technical obstacle to running high deficits if we take care of the balance of payments and national insolvency by import and capital controls. Obviously, such closing of the economy entails severe efficiency losses, but this is the price one must pay for a free hand on the budget. We now know all about the last-resort potential of the printing press and the docility of bond markets.

Against this slightly cynical view, the long-term argument is that if you run deficits even of 3 percent of GDP, let alone much more, year after year, while your GDP grows by only 1 or 2 percent, let alone less, year after year, you are in deep trouble before you know where you are. Of course you do not plan to remain profligate year after year, but like drug-taking, it is easier to start than to stop running high deficits. Inflation can boost the growth of GDP in nominal terms and thus helps ease the weight of the national debt, but it is an incubator of long-term ills; nor is it easier to cure than drug-taking. Nearly all European states are embarking on fiscal stimulation to save the short term, and nearly all are scolding Germany for refusing to do so. The fear is that Germany is free-riding on their programs. Their domestic stimulus generates a spillover into the German economy, but there will be no spillover of German demand into their economy. Germany has so far remained unmoved, with eyes fixed on the long-term fitness of the German export machine. Since 2005 Berlin has put its fiscal house in order and corrected the worst features of its labor legislation. It is reluctant to throw away these achievements. With its biggest and strongest economy playing odd man out, European anti-recession "coordination" remains the empty slogan it was always destined to be, but that is hardly a matter for great concern. It is easy to forget, too, that without German conservatism and stubbornness, the euro would not be excessively firm as it now clearly is, but would be sliding down the slippery slope (as the pound sterling is doing even though the British program of spend, spend, spend has not even begun). In this regard, it is indeed hard to tell who is free-riding on whom, Germany on the rest of Europe, or the other way round.

Nor is it sure that it is wrong to accept short-term pain as the price of long-term fitness, or at least the hope of it.

After decades of Thatcherism, Reaganomics, and "supply-side" emphasis, the dysfunctioning of a hybrid system of finance and the chill wind of recession have sent the makers of opinion and of policy in the Anglo-American sphere scurrying back to Keynesian certainties.

However, for all its admirable originality and inner consistency the Keynesian system has notorious faults. Perhaps the principal one is that it holds out an open invitation to lesser Keynesians to treat the economy as a complex machine made of rigid Meccano parts whose mechanical properties are fixed and known. There is the propensity to consume, the marginal efficiency of capital, liquidity preference and so forth, great impersonal data that make the whole economy move in certain ways when they move—but why do they move? It is all macro and no micro. It is too easy to forget that the data are the sums of human decisions subject to human expectations and they change as expectations change. The eminent Polish economist and statesman Leszek Balcerovicz holds that the authors of fiscal stimulus packages must be taking people for Pavlov's dogs who react predictably to signals because they live by conditioned reflexes and not by calculating reason. He cites studies showing that when national indebtedness is already high, government spending by further borrowing has no or negative effect on private consumption and investment. Not to spend more, but let the economy freely to find its own way, is a better policy. The best of all policies may well be one that has as few policies as possible.

A generation ago it was fashionable to detect regular cyclical movements in economic activity like the rhythm of strong and weak tides or the predictable seventh wave. Statisticians discovered long Kondratiev cycles, ten-year cycles and forty-month cycles. The numbers patiently conformed to the findings. Somewhat similar discoveries, though not based on the complicity of numbers, are sometimes made in political history. The political scientist Francis Fukuyama, who earned world fame with his claim that the onset of "liberal democracy" marks the end of great ideological confrontations, has lately found that there is a swinging pendulum that takes us from extreme interventionism to extreme free market practice and back again. He considers that the pendulum is now on its way toward more dirigisme and less reliance on free markets. (He does not go so far as to say that the pendulum is taking us from capitalism to socialism.) He may well be right, at least regarding the immediate future, for when a movement is clearly discernible, it is a safe guess that it will go on until it stops. The pity is that talk of a swinging pendulum makes a back-and-forth pattern seem inexorable, a Hegelian historical necessity that is destined to sweep all before it. Since theories of history, let alone of historical necessity, have a habit of being falsified by events, let us trust that this minor bit of theory of the policy pendulum will also turn out to be false. It depends on us whether it will.

2. WHO IS AFRAID OF THE NATIONAL DEBT?

With government and compulsory social insurance deficits running over 12 percent of gross national product in Britain, over 8 percent in France and over 7 percent in Germany in 2009, with 2010 promising to repeat much the same, Europe's economy seems to be wading along knee-deep in red ink. Most commentators profess to be scared by the prospect, not so much because of the 2009 and 2010 numbers, but because of what they portend for the years of normalcy that must follow the exceptional emergency from which we are just emerging. Others, a defiant minority, call this "deficit hysteria." Sir Samuel Brittan, the senior columnist of the *Financial Times,* explains that if recovery comes, it will soak up the deficit and reduce the debt, while if it does not come soon, it won't neither ought it to. Keynes might not have put it differently.

Much of the Keynes-bashing of recent decades was a reaction to the adulation surrounding a rather deformed and naïve image of Keynes in the decades following the Second World War. Without going into the subtleties of what Keynes really meant and how he was misinterpreted, one might usefully separate Keynesian economics from Keynesian mechanics. The latter at least is incontrovertible, resting as it does on the proposition that like all accounts, the national accounts always balance. They may balance at high or low levels of total income. An intended change in one item of the account is either accommodated by intended changes of the opposite sign in other items, or the intentions must be frustrated by a lower (or, subject to physical constraints, a higher) level of total income at which intentions are revised and mutually accommodated.

One might, for argument's sake, envisage that people in an Anglo-American style economy, who have been getting ever deeper into debt in the last ten years, decide to mend their ways and reshape their bud-

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gets, so that intended net household saving moves from around 0 to 5–7 percent of disposable income. A simultaneous increase in net government dissaving (roughly, the budget deficit) by an extra 4 percent or so would offset this. Assuming that nothing else changed, a fall in private debt would simply be balanced by a matching increase in public debt. Of course, corporate net saving or dissaving and net exports may all change at the same time, and in 2008–09, the sum of all these changes was such that gross national product was reduced by 2.5 percent. None of this is meant to indicate the direction of causation nor the policy that, adopted in timely fashion, might have altered the course of these variables. All that is meant is that a rise in the net national debt *may* be mechanically offset by a fall in private debt. Another way to describe this is that the issue of government bonds is taken up by private savers. Does this mean that nothing much is wrong, for as the saying goes, "We owe the national debt to ourselves"?

Everyday plodding rather than emotion is needed in approaching this problem. To begin with, the debt is in part owed to ourselves, but in part we owe it to foreign (mainly Chinese, Japanese, and Gulf Arab) institutions and individuals whose saving covers the part of government dissaving not offset by our own domestic saving. In the accounts, this appears as negative net exports or capital imports. Our own net wealth decreases and some of our gross worth comes to be owned by foreign savers. In an age of globalization, this is not a catastrophe. It does mean, though, that our future balance of payments will be forever burdened with the service of this debt and if net exports continue to be negative, the burden will continue to increase year after year. It must be discharged or it will be added to the existing debt and thus augment the annual burden to be discharged. Ultimately, this must put the competitiveness of our economy to an increasingly severe test.

This is not a matter for despair, for the competitiveness of an economy can undergo a vast sea change in a mere decade or two. The United States was hugely competitive in the 1950s and 1960s and Europe was groaning under a "dollar shortage," but no later than 1971 President Nixon felt compelled to abandon the gold exchange standard and introduce an "interest equalization tax" to protect the U.S. foreign capital account. Be that as it may, the seeds of a problem are