

## WHERE KRUGMAN WENT WRONG

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Paul Krugman, writing in *The New York Times* on September 5 under the title "1938 in 2010", chastizes president Obama's economists once more for doing what they have promised not to do: to repeat the mistakes of president Roosevelt's economists in 1937 in pulling back fiscal stimulus too soon. According to Krugman, while president Obama's policies have limited the damage from the financial crisis to the economy, they have been too timid in opening the spigots to make money flow, as shown by levels of unemployment that is still disastrously high and increasing. He advocates applying more stimulus, nay, a burst of deficit-financing of the same order of magnitudes as that during World War II, which can amount to roughly twice the value of GDP, or \$30 *trillion*.

The drive of Krugman's argument is that even an exorbitant increase in the national debt would be safe. It would not put the nation in danger of bankrupting itself — just as it didn't in WW II — because the accumulated debt could be easily paid off with the aid of the high level of economic growth that only such an extreme stimulus could generate. He says that the war debt was paid off painlessly during the post-war boom. The economy was able to thrive without continuing deficits, thanks to the improved financial position of the private sector. The moral of the story, he says, is that when the economy is deeply depressed, the usual rules don't apply. Austerity is self-defeating: when everybody is trying to pay down debt at the same time, the result is depression and deflation, and the debt problems grow even worse. Conversely, it is possible — indeed, necessary — for the nation as a whole "to spend its way out of debt and back to prosperity". A temporary surge of deficit spending, on a sufficiently high scale, can cure the problems brought about by past excesses. It is precisely deficit spending on such a scale that is needed to create the economic boom that would lay the foundation of long-run prosperity.

It may be admitted that Krugman's argument has a certain intellectual appeal, much like Keynes' siren song about pump-priming in 1936 had. However, his drawing a parallel between retiring debt after WW II and the proposed retirement of debt after a \$30 trillion spending spree by the government is invalid. Why? The short answer is: because in 1945 the U.S. was still on a gold standard with the result that gold could be invoked to act as the "ultimate extinguisher of debt". However, in 1971 the last vestiges of the international gold standard were thrown to the winds, leaving the world without such a tool. Suggestions of Friedman, that the irredeemable dollar could fill the golden shoes provided that its printing was strictly limited, spectacularly exploded during the present financial crisis. Ever after 1971 the total debt in the world could only increase, never again to decrease — save default. And increase it did with a vengeance. That gave us the Debt Moloch devouring the world. The only way to avoid that fate is to go back to the international gold standard — a solution which, surely, Krugman wouldn't think of advocating. Krugman's placidity and complacency in the face of the runaway debt tower is explained by his wrong interpretation of the historically low interest rates prevailing in the U.S., and his apparent ignorance of the mechanism whereby government debt is monetized. A word as to each of these two perceptions is in order.

1. Keynesian economists offer a false interpretation of the artificially low interest rates at which the government is borrowing as a test of soundness of government credit, and as a

measure of safety of investing in it. This shows, they insist, that all is well with our fiscal affairs. They go further. They treat low rates as a green signal on the road to mega-deficits. Yet the facts tell us a different story. Upon comparison we find that in prosperous times, when our debt and tax burden was relatively small, when total debt was being reduced year in and year out, when public credit was as solid as it could be, the interest rates on government borrowing were much higher than they are now. Government bonds were bought by genuine investors using genuine savings. Bond speculation was non-existent. The government was compelled to borrow in a competitive market.

Excessively low interest rates on government securities are not a healthy sign. They are symptomatic of a depression. They are evidence of the fact that funds to be lent go begging. There is a widespread lack of confidence in business circles. The lethargy of businessmen prevents them from expanding production and making new investments. They do not see how profits could be made that could beat interest rates, however low the latter might be.

2. Keynesian economists are also guilty of deliberately obscuring the mechanism whereby the debt of the government is monetized by the banking system. They want to create the impression that the public, that is, individual investors at home and abroad buy the government paper for purposes of saving. The truth, however, is that individuals have long since stopped saving in the form of government paper, which they look at as “certificates of guaranteed confiscation”. Their role has been taken over by the bond speculators who make a killing on their holdings when interest rates go down, and they make a killing on their short positions in bond futures when interest rates go up. They make their profits at the expense of the public. Recall that such profiteering is ruled out under the gold standard that stabilizes interest rates and bond prices.

But — and this is what Keynesians are hiding from the people — by far the largest part of government debt is held by the banking system. To the extent that banks finance government borrowing future (as opposed to present) savings are being used, with disastrous consequences. The government sells its bonds to the banks; the banks use these as assets and create demand deposits against them, thus acting as an intermediate agency for converting the government’s promises to pay in the distant future into bank deposits that can be used immediately as cash. The ratio of reserves to deposits declines. The banks receive a tiny profit in the form of a low interest payment on the bonds for putting their credit-clearing facilities and their cash at the disposal of the government. This procedure is called “monetizing government debt”, and it can continue until surplus bank reserves have been exhausted.

Monetization of government debt by the banking system is a thoroughly bad policy. It is the engine of inflation as deposit currency payable on demand is created against the government’s promises to pay in the distant future. It is the classical example of borrowing short and lending long.

But it could also be an engine of deflation. Here is what happens. Bond speculators are watching. When the banks are overextended, they dump the bonds *en masse* causing a steep rise in the rate of interest. The corresponding drop in bond prices would wipe out the entire capital and surplus of all banks simultaneously, as it happened in 1920 and, again, in 1980. The abrupt and steep rise is then followed by a slow, extended fall in interest rates. Such a fall has the effect of destroying capital across the board, as the liquidation value of debt rises. This means prolonged deflation that feeds upon itself. This is the true explanation of the Great Depression of the 1930’s, and this is the story behind Great Depression II now unfolding.

It must also be remembered that taxes must be levied to repay the government debt. Here Keynesians have another “blind spot”. Higher taxes dull the efficiency of the private sector in creating wealth. As the government repays the loans, money will accumulate as surplus reserves in the banks and will then start scrambling in search for outlets. The only way

these surplus bank reserves can be used is for the people or the government to borrow from the banks again. Thus deficit spending breeds more deficit spending and debt breeds more debt. Bank capital is at risk when the rate of interest rises but, for different reasons, it is also at risk when the rate of interest falls.

Keynesians are fond of saying that government debt does not matter because “we owe it to ourselves”. This is a vicious notion. The next generation will have to pay heavy, repressive and disturbing taxes, *not to themselves*, but to pile up surplus bank reserves. The wealth that future generations have yet to produce will be used to retire the currency now being issued against it. To achieve this “miracle”, people are being put into debt-slavery to the banks, and into tax-slavery to the government. *This is a recipe for perpetual deflation, or for perpetual inflation*, or a mixture of both.

Only an austerity program can stop the runaway debt tower, and that only under a gold standard. It is a great pity that Krugman has, as Keynes did before him, completely failed to comprehend the nature and the role of the gold standard as the regulator of the level of debt, that would sound the alarm if safe levels of indebtedness were exceeded.

September 9, 2010.

### Calendar of events

#### **SOUND MONEY OR UNSOUND — THAT IS THE QUESTION**

*Symposium of the New Austrian School of Economics in Auckland, New Zealand*

*November 15-19, 2010*

Lecturers: Professor Antal E. Fekete (Hungary), Rudy Fritsch (Canada),  
Sandeep Jaitly (U.K.), Peter Van Coppenolle (Belgium)

Nov. 15.	a.m.	Sound Money: Unadulterated Gold Standard
	p.m.	Unsound Money: Irredeemable Currency and Our Diseased Monetary Bloodstream
Nov. 16.	a.m.	Fiat Currency: Destroyer of Capital
	p.m.	Fiat Currency: Destroyer of Labor
Nov. 17.	a.m.	When Atlas Shrugged: the Lure and Lore of Risk-Free Profits
	p.m.	Gold and the Babeldom of the Debt Tower
Nov. 18.	a.m.	The Fall and Rise of the Gold Standard
	p.m.	Sound, Less Sound, Least Sound: The Unhappy Tenth Anniversary of the Euro
Nov. 19.	a.m.	And God Created Gold...
	p.m.	The Gold Standard Manifesto

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