In a Free Market, Money Doesn’t Grow on Trees

"Economics is haunted by more fallacies than any other study known to man," economist and journalist Henry Hazlitt once pointed out. "The inherent difficulties of the subject … are multiplied a thousandfold by a factor that is insignificant in, say, physics, mathematics or medicine — the special pleading of selfish interests." In the introduction to his epigrammatic classic, *Economics in One Lesson*, Hazlitt explained that special interests and their kept economists have always been skillful at sowing public confusion over sound economic principles: "The group that would benefit by [bad economic] policies, having … a direct interest in them, will argue for them plausibly and persistently. It will hire the best buyable minds to devote their whole time to presenting its case. And it will finally either convince the general public that its case is sound, or so befuddle it that clear thinking on the subject becomes next to impossible."

Not much has changed since Hazlitt first made those observations more than six decades ago, except that public confusion over free-market economics is deeper than ever and the free market is considerably more hamstrung by government interference than it has ever been previously.

The financial crisis that has engulfed the world in recent months has given more ammunition to the enemies of liberty, especially the rhetorical and political saboteurs whose aim it is to eradicate economic freedom with full-blown socialism. Their arguments — that the markets need "fixing," that private-sector greed is responsible for the mess, and that freedom, at least where the markets are concerned, simply does not work — are the same warmed-over fallacies that Hazlitt (and others before and since, like Bastiat and Rothbard) devoted his life to refuting. The truth is that the current financial crisis has been created not by the free market but by government interference in the operation of the free market.

But in times of crisis, anti-free-market fallacies have a way of reappearing and capturing the fancy of a public weary of bad news and desperate for anything that will restore market sanity and, more importantly, return their vanished wealth. Hazlitt and other champions of freedom and free markets understood that the enemies of freedom can be counted on to exploit every opportunity to spread their falsehoods, so they worked tirelessly to help the common man to understand and appreciate the virtues of free-market capitalism. In that same spirit, we presume to offer a timely treatment of some of the most conspicuous anti-free-market fallacies, to remind the reader of the virtues of economic freedom and of the root causes and cure for the financial and economic meltdown.

FALLACY #1: *The free market does not work perfectly because unfettered capitalism is too disorderly. Government is needed to impose limits on speculative excess, prevent price fluctuations from becoming too severe, and in general to exercise benign control over a lawless domain of human activity.*

Answer: "Order" is a popular synonym for government, especially among those who believe no problem is too big or too complex to be solved by the creative application of government force. But is "order" more important than liberty? Other freedoms — the freedoms of speech and of religion spring immediately to mind — are also sometimes conducive to social disorder. A monolithic state religion and rigid censorship of controversial speech are likely to impose more "order" than their absence (and were once defended on precisely those grounds), but Americans are still willing to accept the risks and the disorderliness that inevitably arise from these freedoms. The benefits associated with freedom of religion and speech are rightly held to greatly outweigh the risks — this despite the fact that religious freedom has sparked numerous wars, and printed and spoken words have been responsible for epochal upheavals in human affairs.

But in truth, although a planned economy may be more "orderly," at least in the abstract, it is immeasurably less productive than the free market. No cadre of central planners, no matter how enlightened, can possibly make better market decisions than individual consumers with their countless millions of choices, great and small, made every day in a free-market economy. It is those choices in the aggregate that create the great web of supply and demand, with its constant fluctuations depending on a myriad of factors beyond the control of any government agency. When demand for a given product declines, so too will its supply, over time, and other products to satisfy human needs and tastes will arise to take its place. When a given producer overestimates public desire for his product and produces more than he can sell at a hoped-for price, the price will go down.

The free market, in other words, is a spontaneous extended order that, left largely to its own devices, will regulate itself, as consumers and producers decide for themselves what things shall be produced, at what price, and in what quantities. This applies not only to consumer goods like groceries and clothing, but also to stocks, bonds, other financial instruments, real estate, and even money itself — which is, after all, just another consumer good, albeit one with a very important purpose.

The idea that government can do one better on the free market is ludicrous. It is tantamount to saying that the government knows better than this writer, or the reader, or the man on the next barber stool, what economic choices to make for himself. The free market is the ultimate democracy and (unlike pure political democracy) works better than any possible alternative, occasional uncertainties notwithstanding.

FALLACY #2: *Free markets do not work because of human greed. Accordingly, government is needed to keep man's predatory instincts in check.*

Answer: We agree that the government has a responsibility to enforce contracts and punish fraud. But men should be as free as possible to enter into contractual agreements and to take responsibility for the risks associated with them. *Caveat emptor* — let the buyer beware — is hackneyed but still spot-on. Men should have legal recourse when others steal, lie, defraud, or refuse to fulfill the terms of a contract. But men have no moral right to enlist the power of the state to bail them out of bankruptcy or otherwise intervene whenever they do not wish to suffer the consequences of bad business decisions.

Certainly wealthy men can be greedy, but there is no better restraint on "corporate greed" than the freedom to fail. When failed businesses of any size are bailed out with taxpayer monies, when dominant corporations receive special treatment, government, not the private sector, is encouraging what is known in economics as "moral hazard," the tendency to take greater risks and be less provident with capital resources than would otherwise be the case — in other words, to get greedy.

Thus the free market tends to punish greedy behavior, while government interference encourages and even rewards it. And lest we forget, the wealthy capitalist with all his money cannot compel men one iota to do his bidding — unlike government, with its armies, prisons, and police forces. Which of the two is therefore the more deserving of popular vigilance?

FALLACY #3: *Economies grow when people open their wallets and spend, and stagnate when consumers are reluctant to spend. Therefore, governments and central banks need to encourage people to keep spending, to keep the economy moving.*

Answer: This peculiar economic fetish flies in the face of everything our parents ever taught us about money. Remember "a penny saved is a penny earned"? How many of us were encouraged by our parents to spend as much of our allowance or earnings as we could, rather than save money, because spending is better for our personal economic health? What is prudent conduct for families and individuals — savings and thrift as against spending — is no different for nations or the economy as a whole. Just as individuals cannot spend themselves into prosperity, so too excessive spending — by governments, corporations, or any other large-scale economic entity — will lead to ruination in the long run. Savings, not spending, is the basis of any nation’s or individual’s wealth, yet our government and captains of finance almost universally disparage savings and believe that only consumption can keep our economy healthy.

What is the origin of such a patently nonsensical belief? In large part, it has arisen from the way in which money is created in the modern world. With the demise of the gold standard worldwide, all money in circulation today is created by the Federal Reserve and other central banks throughout the world. Although the issuance of "fiat" paper money amounts to printing notes on paper not backed by gold or anything else, the way that this is accomplished in practice is a little more subtle. Central banks, including the Federal Reserve, pump new money into the economy by issuing debt, which expands the amount of money available in bank reserves and ultimately creates a demand for more money in circulation. But the viability of the entire system depends crucially on the willingness of corporations and consumers to take on debt. If the public should become too thrifty, relying on savings rather than credit, the ability of the banks to expand the money supply would be severely impaired. To avoid this, the Federal Reserve and other central banks routinely lower interest rates far below natural market values, to entice individuals and corporations to keep borrowing and spending, rather than to save. The infamous real-estate bubble was created by just such an artifice, in which credit became so cheap that millions of Americans were gulled into taking on multiple mortgages and acquiring extravagant houses far beyond what their means would permit in a marketplace not distorted by unnaturally low interest rates.

This pernicious practice of lowering interest rates to enable the government and central banks to print money at will has been carried on for so long that large numbers of people have allowed themselves to be persuaded that, after all, spending and debt make much more sense than dull, old-fashioned living within their means and saving money. Add to that the fact that the dollar has lost most of its value over the last several generations, and saving money whose value will disappear over time looks very unappealing.

FALLACY #4: *The Federal Reserve may have its faults, but it plays an important role in stimulating economic growth by prudently expanding the money supply.*

Answer: This fallacy rests on the confusion of money with wealth. Printing new money does not — indeed cannot — make us richer as a whole. All it does is increase the amount of money relative to other goods and services, causing prices to rise over time. This process — the expansion of the money supply by central banks acting in cahoots with government — is called inflation (not to be confused with rising prices, which are the effects, not the cause, of inflation).

Put otherwise, if you have a very rare baseball card, of which only a handful remain, you have a collectible of considerable value. But if someone somewhere finds an entire box full of such baseball cards hidden in an attic and sells them at an auction, the value of your card will drop, because it will no longer be as scarce. In similar fashion, the value of the dollar is diluted as more and more come into circulation through the process of inflation. This is why prices have risen steadily year after year, eroding the value of the dollar and of savings.

When bogus money is pumped into the economy by the Federal Reserve, people come to believe that growth is occurring. Cheap credit, the concomitant of a loose-money policy, encourages feverish borrowing and spending, and a boom follows. Of course, at some real level far removed from the inflationary cloud-cuckoo land, real growth *is* taking place, as more and more goods are produced, land is developed, and payrolls increase. But this growth is far removed from the wild-eyed expectations of a public intoxicated with easy money. Sooner or later, reality rears its ugly head, and, as surely as the hangover after the bender, the bust follows.

Of course, the temptation is great to try to avoid the bust by pumping even more easy money into the economy. But the bust cannot be avoided forever — and the greater the bender the worse the hangover will be.

If wealth could be created through money creation, then every American could be made an instant "millionaire" by mailing him a check for a million or a billion dollars. The federal government could then go to the Federal Reserve to borrow the money it needs to back those checks, and the Fed could create the money out of thin air — just as it does now, albeit on a smaller scale. But how much food would a million dollars then buy?

Quite aside from economic concerns, inflation is also a moral evil, not only because it is based on a lie, but because its effects are felt differentially. When new money is first introduced into the economy, the primary beneficiaries — those at the top of the economic food chain, like big banks, major investment firms, and corporations that conduct business directly with the government — perceive it as a benefit, because prices have not yet risen to reflect the appearance of the new money. They are like the members of a hypothetical counterfeiting ring who enrich themselves by printing money and then spending it on themselves. They are happy, and the merchants with whom they transact their business are happy, because the new money, having just been introduced into the money supply, has not yet caused prices generally to rise.

But in the longer run, the new money in circulation will cause consumers to bid up prices, to the general and long-term detriment of the economy. Inflation thus enriches a few, who have access to new fiat money before anyone else, at the expense of all the rest, who only become aware of inflation after prices at the supermarket and the gas pump rise and the value of their savings deteriorates.

Even more reprehensibly, inflation is in fact a kind of tax, but withal a much less honest one than property or income taxes. Governments always prefer to print money for revenue rather than raise it through taxation whenever they can get away with it because the nature of inflation is so hard for many people to recognize. People pay the tax exacted by inflation in the form of a depreciating dollar and devalued savings rather than in a direct levy, but the effect is the same.

Because of its deceptive nature, inflation is the preferred means of funding wars and unpopular big-government programs. It is no accident that, since the advent of modern central banking, the scale and expense of military spending and warfare have increased many fold. So too has our federal government expanded to gargantuan proportions since the Federal Reserve first fired up its printing presses. The modern welfare/warfare state with all of its injustices depends crucially on inflation and deficit spending for its lifeblood. If the money spigots at the Federal Reserve were someday turned off, as a few lonely voices like Congressman Ron Paul have been advocating, much of the outsized federal government would wither on the vine as taxpayers and their servile representatives in Congress balked at footing the entire bill by direct taxation.

FALLACY #5: *Say what you will, the government still needs to step in from time to time to rescue a corporation or an industry too important to our national economy to be allowed to fail. This requires general sacrifice, but it is better than allowing the collapse of an indispensable corporation or industry to bring down the entire economy.*

Answer: The failure of a corporation, even a large bank or financial company, will not bring down an entire economy. What happens in the free market when a large, inefficient corporation fails is that its assets are acquired by more efficient producers. This happened recently with the assets of Bear Stearns, Merrill Lynch, Wachovia, and Washington Mutual. When governments undertake to prop up or bail out inefficient corporations on the basis of specious arguments like the "too large to fail" canard, it is simply subsidizing inefficient producers at the expense of efficient ones (and saddling taxpayers with the tab). The idea that failed large corporations leave gaping rifts in economic productivity is absurd; their assets are simply purchased by other players and put back into productive work. When an airline fails, it does not junk its airplanes and other valuable assets, but instead sells them to a willing buyer, and its best employees are typically retained under the new management.

Variants of the "critical industry" or "too big to fail" argument commit the cardinal fallacy of false economics, the failure to trace the consequence of a particular policy to its general and long-term effects, not merely its targeted short-term effects. Without doubt, individual corporations — their boards of directors, shareholders, and employees — benefit in the short term from a government bailout. Book assets are propped up, jobs are kept secure, and company morale is boosted. Given enough time, some corporations, like Lee Iacocca’s Chrysler, may even right themselves and return to profitability. But the question that special interests lobbying on behalf of such government interference never consider is the general effect on the rest of the economy. Special interests are, after all, special; they are not paid, nor is it in their short-term best interest, to consider the "big picture." Yet good economics, as Hazlitt pointed out, "consists in looking not merely at the immediate but at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but for all groups." And as prudent citizens and taxpayers, we ought to do likewise.

The hard truth is that government bailouts benefit none but the special interests thus rewarded, and possibly the politicians who reap the kickbacks. The money used for bailouts comes, directly or indirectly, from the taxpayer, money that would otherwise be used for more productive purposes in the free market. More efficient competitors and would-be purchasers of the inefficient corporation’s assets are at a disadvantage; they are in effect being penalized for their frugality and efficiency to the same extent that the beneficiary of the bailout is being rewarded for its profligacy and inefficiency. And of course, the immense sums often involved in government bailouts, like the $700 billion dollar abomination recently passed by a supine Congress, will become the taxpayers' liability for generations to come.

Freedom Works

To claim that the free market "doesn't work," as choristers in the media, in Washington, and on Wall Street have been crying for months, is to cast doubt on the viability of freedom in the first place. For the past couple of centuries — a vanishingly brief interlude in the total sweep of human history — the light of freedom has spread, in varying degrees, throughout much of the world. Only a few generations ago, the greater part of the world accepted such articles of political faith as the divine right of monarchs, chattel slavery, a state religious monopoly, and state censorship. Near-absolute curtailment of liberties — economic, political, social, and spiritual — has been the rule, not the exception, even among comparatively enlightened societies in ages past.

The fledgling United States of America were the freest and most perfect republics the world had yet seen. But early America was not merely the embodiment of political freedom. The Founding Fathers were keenly aware that freedom also must extend to the all-important realm of economic activity. Most of them (Alexander Hamilton being a notable exception) championed a free market with a minimum of state interference. The writings of Turgot, Adam Smith, and other lesser-known free-market economists were familiar in early America. In economic matters as in other spheres of human activity, it was widely believed that freedom to choose would prompt citizens to solve problems and improve their condition far more effectively than government coercion could hope to accomplish.

So deeply and widely held were such convictions that, during America's first great financial and economic crisis, the Panic of 1819 (which lasted roughly two years), arguments against government interference in economic affairs were set forth so robustly and vigorously in many states that proposals for state-funded relief of bankrupt individuals and corporations were roundly rejected by legislatures, and schemes to engage in inflationary activity were regarded with narrow suspicion. Although relief measures found support in some quarters, the arguments of Virginia state representative William Selden, as summarized by economist Murray Rothbard in his history of the Panic of 1819, were typical of the prevailing sentiment:

Selden stressed the importance of personal responsibility for contracts and actions; the debtor should "pay the consequence of his own folly of imprudence." In short, freedom of contract must be maintained; "Leave men alone to make their own contracts, and leave contracts alone when they are made."

From such statesmanlike sentiments, modern America has gone very far astray. Many of us, and nearly all of our political leadership, have come to believe in the illusion of prosperity through government force, carried out by micromanagement of the economy and manipulation of the money supply. But true prosperity — wealth — is not to be attained by printing money, nor a robust economy by central planning in any degree of intrusion.

Ah, but we must do something to save our faltering economy, the socialists say. Indeed, we must do something. But it is the height of stupidity to think that we can "rescue" the economy by doing more of what caused our economic downturn in the first place — more government spending, more creating money out of thin air, more artificially low interest rates, and more debt. The key to restoring the economy to good health is to stop harming it, and that means that we must stop creating money out of thin air (which means reinstituting the gold standard), allow market forces to set interest rates, and limit government to its proper constitutional size.

Contrary to the pleading of her many enemies, freedom does work, as the miraculous success of the United States of America and other comparatively free nations bears eloquent witness.