What's Wrong With the Economy?
Guest: Robert P. Murphy
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WOODS: Now you have a blog post, and that's what made me think it's time to have MURPHY back on here. And you're talking about Paul Krugman's summary of what Larry Summers recently said at the IMF. Now, apparently, Summers is suggesting that insanity is going to be the new normal. Can you unpack this?

MURPHY: Sure. So I think the first thing to make sure your listeners understand is what Krugman means by a liquidity trap.

WOODS: Right. Explain this.

MURPHY: All right. If the economy slows down, even Keynesians like Krugman ostensibly would say that doesn't call for fiscal action. The central bank has the power to fix it. They just lower interest rates, because with a lower interest rate people in the private sector are going to spend more on consumption, spend more on investment. You don't need the government to come in and run a budget deficit to fix the economy.

Even Krugman says that's the official position, except when you get into a liquidity trap, because, suppose the economy is in such dire straits that aggregate demand is so much falling short of where it needs to be for full employment that the Fed pushes interest rates all the way down so that a nominal level is zero percent, and yet, there's still a shortfall. You still have high unemployment. And so, Krugman's point is, obviously at that point, standard monetary policy loses traction because you can't make nominal interest rates go negative.

So that's where now everything you normally think of as the standard laws of economics get turned upside down, because now you're in the liquidity trap. So here Krugman says the government wasting money is actually a good thing. You don't want the government to be penny pinching and balancing the budget when there's a liquidity trap on. You want it to waste money. You want the Fed to make people think there's going to be high inflation in the future, because that will then make them spend money now.

So the normal sorts of things that you associate with good governance, Krugman says, go out the window when there's a liquidity trap. So, throughout this crisis, he's been pushing these policy views, but he always says, "Hey, I'm not a nut job. Once we get out of this recession and things get back to normal, then I'm going to go back to worrying about the budget deficit. I'm going to agree that savings are a good thing," and all that kind of stuff. "It's just during this

liquidity trap where things get turned upside down and all these normal economists who aren't Keynesians are giving horrible advice."

WOODS: Bob, forgive me. Let me interrupt for just one second. And I realize this is a bit of a tangent, but we should touch on it.

I think a lot of times libertarians who read Krugman or are vaguely acquainted with Keynesianism think the normal Keynesian prescription is always to have deficits, or always build bridges and then blow them up, and then build them again and blow them up again, and so on. I think it's important to explain that's not really the case. But on the other hand, is that really libertarians' fault, or is there some aspect of Keynesianism that might lead somebody to think that that's what they're saying?

MURPHY: That's a good question. I think it's a little bit of both. It's certainly true in terms of the standard text of new Keynesian theory that you're not supposed to run a budget deficit just to fix a depressed economy so long as interest rates are positive. The standard theory says no, that just wastes resources; go ahead and have the Fed cut interest rates, or the central bank lower interest rates. But, it is true that in practice I think you won't see that as much and that, also—old Keynesianism, I think that was their standard view. They had a thing about, you run deficits when there's a recession, and then you run surpluses when there's a boom, so that you have a balanced budget over the business cycle. That sort of thing. Also, it's very convenient that, when there's a Republican in office, that's when Krugman was being very much a budget hawk, in terms of, "Oh, my gosh, he's irresponsible, tax cuts for the rich, I can't believe it." So, again, it depends on how fair you want to be. It's certainly true you can point to textbook new Keynesian theory, not old Keynesian, but new Keynesian theory that makes these subtle points. But in practice, I think it is true that the people who call themselves Keynesians do seem like they're always coming up with good reasons why they ought to be spending money right now.

WOODS: Let's get back to what you're describing now, then. As Krugman has been saying, because we're in a liquidity trap, as he says, there are certain laws of economics that don't apply right now, but they will apply when we get out of this. So now, how does Larry Summers affect this overall picture?

MURPHY: Okay, so, now in that context, at the recent IMF conference, Summers presented this shocking paper, or this big deal paper, and Krugman is summarizing it on his blog saying, "You know, hey, I've been going along these lines myself and Summers just came out and said point blank that we need to face up to the fact that we may be in this liquidity trap for a long time, that we've been on the verge of falling into it since the 1980s, and the only thing that's kept us out of it has been a series of bubbles." And so they're saying the entire nature, the whole structure of the US. economy from the 1980s until now and for the foreseeable future is such that, unless we have a string of bubbles, we're going to fall into a liquidity trap. And so it's sort of like they warm people up for a few years by saying this is a very temporary, odd situation where normal policy recommendations and things that seem like prudence are actually a bad

idea, but now they're kind of saying, "Oh, by the way, this stuff we've been telling you for the last few years, this is going to be the standard going forward."

And just to give you an example of what I mean, over the next day or two Krugman had a post talking about Social Security, and he said,it's good if you expand Social Security so that people save less. So, he's saying we need to come up with things that make Americans save less, and he's not talking about next fiscal quarter or something; he's saying, in terms of going forward into the future. "The problem right now is that people are saving too much." I mean, he's really taking this to mean this is a long term structural change now, because the U.S. economy as it is is addicted to bubbles, and all these policy recommendations flow from that view.

WOODS: All right, so on Larry Summers, we've got now a subsequent interview that was excerpted over on ZeroHedge that you and I read before we started chatting. He was asked how he felt about bubbles. He said, "Well, I don't favor bubbles." But he had been saying we had only been able to have growth because of bubbles, so maybe we need a new framework in which we can have growth without bubbles. But someone like David Stockman has been saying sort of the same thing, right? That what we've been seeing are these bubbles that bump up the numbers, that make it look like we've got a lot of employment, we've got a lot of economic activity—but in terms of real economic indicators, they really haven't been so good for the genuine health of the economy. So it's interesting that both Stockman and Summers would say there's something unnatural about what's going on here.

MURPHY: Right. That's a very good point, and I'm glad you made that connection, because I was thinking the same thing, that let's just be clear, and make sure we understand what Summers's nuanced position is. It's sort of like when Krugman is caught now with that infamous line where he said, "Oh, Alan Greenspan needs to replace the dot-com bubble with the housing bubble." And now he's denying what he meant by that. But, the same thing with Summers. He's not saying, "Oh, it's a good thing that we kept having bubble after bubble, and going forward policymakers need to do whatever they can to encourage a bubble." That's not what he's saying. What he means is, "Given the way the economy is right now, if policymakers don't take my strong medicine and really totally reform everything along my blueprint, then the only way we avoid the liquidity trap is to have bubbles." And so, you're right, though. It is kind of ironic that on the one hand you've got guys like Summers and Krugman who laugh at paranoid nutjobs like Ron Paul, and Stockman, and Tom Woods and Bob Murphy, who, ever since Nixon closed the gold window, have been telling us the economy's been fundamentally screwed up and *blah, blah, blah,* and they keep warning about how awful that's gonna be. But nothing really bad's happened. What's the problem, guys?" And then they're admitting, "No, the whole U.S. economy, the whole structure of it for decades now, has been dependent on bubbles to avoid a catastrophe."

WOODS: You would think that would make them apologize: "Even though we don't agree with our opponents on everything, they did have a basic insight here, that things sort of went screwy 40 years ago."

MURPHY: Right. Yeah, and what we're really disagreeing on is how to fix it. But certainly, they're now coming over to our point of veiw and realizing that, yeah, something was structurally, fundamentally screwed up with the whole U.S. economy for decades at this point. And you know, another thing, too, and this is sort of a subtle point, but remember what the smoking gun was that they used against us, and Larry Summers does it in the same interview where the ZeroHedge people are quoting from, is that he says, clearly, these what he calls "austerians," these inflation hawks, have been wrong because they've been warning that quantitative easing (QE) is going to give us hyperinflation, and they've been wrong. But by his own logic, the reason there hasn't been big inflation over the last few decades is because bubbles were there sort of soaking up things and then getting the economy to jump from bubble to bubble. So by his own acknowledgement, you could have an economy that is seriously screwed up, jumping from bubble to bubble, without seeing CPI go through the roof every four years. And so why are we so nuts saying right now that QE is causing another bubble, if that's his own view of what's been going on?

WOODS: Now, I want to talk about QE in a few minutes, because in this Larry Summers interview he gives an endorsement of it. I guess there had been something of an urban legend according to which Summers had been an opponent of QE, or he might have been .03 percent more of an inflation hawk than Janet Yellen, but I want to get back to this idea that we're in a liquidity trap and therefore have to discourage saving as best we can. We've got to get people and governments spending on ridiculous things, because, in this case, it makes sense because all bets are off. The traditional laws of economics don't hold. What do you, as an Austrian economist, say to that? And I know that's a big question, because I think your answer would be that the whole framework underlying this way of thinking is all wrong. But what would you say?

MURPHY: Right. That's the main thing. They're viewing the sole function of interest rates as to be a lever that causes total spending to rise or to fall. Thus the response: "Oh, my gosh. There's a shortfall in demand; why aren't you going to lower interest rates to boost spending up?" And then, "Aw, shucks. If that doesn't work because we hit zero, now we've got to do some unorthodox thing like promise future inflation, or have the government start building bridges that don't go anywhere. That's better than nothing." And so, yeah, one major objection to that from an Austrian perspective is that you're totally misconstruing what it is that interest rates do, and you're setting the economy up for boom-bust cycles by pushing down interest rates whenever the economy slows down, which causes the problem itself.

You know, the thing, too, is that prices can certainly adjust, and part of what's happening is people anticipate that the Fed is going to come in and intervene and do things to prevent dreaded deflation. But, I mean, if the Fed just stood back and let the bottom fall on this stuff, yeah, it would be awful for six months, but then everybody would adjust to the new situation. They would form their new expectations. You'd hit a legitimate bottom, and then you'd grow from there. And yeah, a lot of prices would fall. But it's not that tractors would disappear. Farmland wouldn't disappear. Skilled people wouldn't lose their mental ability just because prices fell. You'd still have the same real economy. Things would just get rearranged, and then you'd go forward. So this idea that we're stuck in this decades-old slump now because of some

quirk about negative real interest rates to me just seems to totally misconstrue what interest rates do and the ability of the market to adjust to a change in growth expectations measured in nominal terms.

WOODS: I think it's unavoidable in this context to say something about QE, because of this interview of Summers. And, as I said, he was asked about QE, and he says that history will look back and overwhelmingly approve the decision to engage in QE And I don't doubt that because history tends to be written by people who support the state. So of course they're going to support QE

So explain what QE—quantitative easing—is. I'm sure we have some listeners who hear this term over and over and they don't really know what it means, and at this point they're too embarrassed to say so because by now they feel like, "I really should know this, and I really don't."

And then, secondly, Bob, a lot of times we say quantitative easing is just a synonym for inflation. And then the sophisticates, like Krugman, come on and say, "What's wrong with you people? It's not inflation. It's just an asset swap." Can you clear all this up for us?

MURPHY: Sure. So, normally, if you think about it, before this recession occurred, when the Fed would announce what it was going to do after a meeting or something, they would always quantify their decision in terms of what they were going to do with the interest rate. You know, "The Fed today announced that it was cutting the federal funds rate by thrirty basis points." Or whatever. It was always measured in terms of what are they doing with the interest rate.

But once that got pushed so low that they could no longer cut interest rates, that's when they switched to announcing how much money they were pumping into the economy. Before this recession, the Fed never told you what they were doing with their balance sheet or how many assets they were buying. You would never have that information. You would have to go look it up yourself. So that's one way of seeing what they mean by "quantitative easing"; they're telling you the quantity of new money they're putting in. Then the various rounds just refer to a major announcement about, "This is how much we're going to spend. We're going to make this amount of purchases over this amount of time."

If you look at a chart of what's called the montary base of the Federal Reserve, you can see there's three distinct periods where it starts zooming up, then it levels off, then it zooms up again. And now we're in the last one, which is referring to the $85 billion a month in Treasuries and mortgage-backed securities that we're still in the midst of. So those are what people mean by the QE 1, 2, and 3. They were distinct announcements about asset purchases the Fed was going to undertake because, oh, geez, it's not working yet. So then, so far as Krugman saying "it's not inflation," I mean, in terms of what does the Federal Reserve do, it creates money out of thin air in order to buy new assets, then gives that new money to the financial sector. But it's still the same process, and they can say, "It's different here because it's not leading to huge increases in prices, so you guys are crazy." The intent is not just to print money, but, I mean, in

terms of what are they doing, yeah, they're creating new money and injecting it into the financial system.

WOODS: Now, don't the various waves of QE correspond to certain policy aims? In other words, QE is not the traditional Federal Reserve policy of trying to fine tune the economy through various injections and so on, but they had particular aims. QE has particular aims involving the housing market. And QE was intimately connected to these particular aims that they had.

MURPHY: Right. I'm glad you brought that up. Different economists had different things in mind. It depends. Are you talking about, what did the Federal Reserve officials say was the reason for what they were doing? And then what did other people say. "Yeah, it's working, but not for the reasons they're saying." So it gets really complicated, but, yeah, why are they buying mortgage-backed securities? How come they're not buying Google stock? Or how come they're not buying land in Thailand or something like that? And, in principle, if the point is just to put money into the system, they could be buying all kinds of stuff, but they're buying Treasuries and mortgage-backed securities, so I would say, of course, part of the reason they're buying Treasuries is that they're monetizing the federal government's debt. The federal government's running humongous deficits and they want to make sure the interest rate on that doesn't get too high and people don't start to suspect that it's unsustainable. That's one reason. And then, even the official rationale for why they're buying the mortage-backed securities was that was going to help contain the panic in the financial system. It was hitting, if you remember, in September of 2008, where it was sort of a vicious downward spiral where if, all of a sudden, people doubted the worth of those assets, then the companies holding them, all of a sudden, were in trouble. And then people couldn't get credit, and so on. And so the Fed coming in and sort of putting a floor under the price of those mortgage-backed securities was supposed to quell the panic and allow the financial system to recuperate.

WOODS: Well, do you think that's responsible? Because, of course, that's the Larry Summers/establishment view. That we would have had a depression had it not been for these bold moves by the Fed.

MURPHY: Well, if you think about it, it's kind of like we're all saying basically the same thing, just from diametrically opposed perspectives. And even Ron Paul, if you asked him what would have happened had the government done what you recommended in September of 2008, he would have said, "Oh, yeah, that would have been an awful depression, but it would have lasted just a few months." So, yeah, those financial firms—I mean, I don't know if he would have used the term depression—but those financial firms holding those assets would all have gone under had the Fed not bailed them out by buying those things at what at the time were way above market prices. So, the broader question, of course, is, was that a good thing to do? The same way, we could ask, when Alan Greenspan slashed interest rates after the dot-com bust and gave us the housing bubble, did he buy a few extra years before the crisis struck? And the answer is yes. If he hadn't done anything and just sat back and let it implode, things might have been worse in 2003 than they seemed actually to people in 2003, but he didn't really do

the economy any favors. He just made the situation fester and made it that much worse. So I think it's the same thing here. Yeah, it is a true statement to say, had Bernanke not done QE, things might have been really bad in the summer of 2009, where, in constrast, it seemed like, "Oh, I guess things aren't so bad after all." That's just because he was masking the problem and letting it fester.

WOODS: Bob, let me read you a brief statement by Summers and get your reaction. He says this: "What caused this crisis is that there was overconfidence and complacency, excessive borrowing and lending, and unsustainable spending. That is what caused this crisis. But now, after the crisis, the only way we will get the economy back to normal is if we have more confidence, more borrowing and lending, and more spending." What would you say to that?

MURPHY: I picked up on that, too. It's hilarious that he, of course, is literally saying what we need to do right now is the exact same thing that caused the current mess, which is what Austrians have been saying, yet he doesn't even seem to realize the irony. At least someone like Krugman kind of acknowledges that, yeah, I realize this sounds crazy, but it's true.

WOODS: Now, Bob, I'm glad that you're noticing this, because I was thinking maybe it's because I don't have a Ph.D. in economics. My Ph.D. is in history. That maybe I'm missing some sophisticated subtlety here, but I'm glad to learn that I'm not.

MURPHY: He doesn't even go out of his way in that particular quote. Maybe he does it elsewhere, but he doesn't acknowledge the apparent problem and then explain: "Just because I'm recommending what I admit got us into this crisis, this time it's going to be a good thing." He doesn't even give a nod to that and explain, so it's hard for me even to get in his head.

If I could just very quickly go back. The reason people are saying that Yellen is better than Summers is he actually, perhaps in an unguarded moment, did write something along the lines of, "I am not sure that further QE would do anything, because right now with interest rates so low, if there are projects people aren't investing in and undertaking at this kind of a low rate of return, it needs to push the interest rates even further negative, and then that makes the project profitable, are we sure we want to be pushing people into those projects?" It was almost an Austrianesque point, and because he had the temerity to say that, that's when all the progressives bit his head off. And guys like—I think it was Matt Yglesias—accused him of being a socialist. In other words, Larry Summers was trying to micromanage some doubt about what the market was going to do, because Larry Summers knew that a project that could only be profitable at a negative two percent interest rate was not a good project. That was the spin they gave to it and bit his head off, because he suggested maybe we don't want to encourage investment in projects that require an even more negative interest rate to be profitable.

WOODS: Bob, if the Summers/Krugman approach here is going to become the conventional wisdom, which it very well could, what kinds of things can people expect? The politicians don't necessarily follow the economists all the time, it's true, but they usually follow them in the worst things they say. So how is this going to affect the average person? And also, how do you

respond to the argument that we have huge scope for monetary inflation because prices are so darned low? So we can afford to do crazy things.

MURPHY: Well, as far as your first question, what does this mean? I think what guys like Krugman and Summers and other sort of intellectual pundits, by which I mean people who don't have Ph.Ds, but guys like Yglesias and Ezra Klein and those kinds of guys—what they do is come up with a seemingly intellectually justified rationale for what the government wants to do. So we can't predict exactly what direction the government is going to move in, but the point is, if they want to go a certain way now, they can cite this stuff and try to explain it, and it percolates up into the more responsible policymaker views so that you can see stuff coming out of the Federal Reserve or the IMF or the World Bank, or what have you. And so I think that's kind of what this is. Guys like Krugman and Summers are the people who throw it out there, run it up the flagpole, and people can see if it's going to stick. As far as if people think, "Oh, come on, prices haven't been blown up so we can afford to keep pushing this until we see some negative consequences," it's sort of odd that even Summers and Krugman are agreeing that this sort of mentality has been getting us bouncing from bubble to bubble for decades now, and so, isn't that one of the negative consequences?

WOODS: Right. Good. Good. Thank you!

MURPHY: That is part of what we've been saying, and it's true. It was, I guess, a tactical mistake, and I, of course, am guilty of this. I thought price inflation was going to be worse now than it has been, but certainly the Austrian theory of the business cycle—the objection that MIses and Hayek made to monetary and credit inflation—was not, "Oh, that might make prices in the grocery store go up higher than the housewives would want." That was never the issue. The issue was it's going to set up a boom-bust cycle. Interest rates serve a purpose, and so if you change them, you're going to screw things up. So all that is still true.

One last thing, though: to the extent that they do keep piling money in it, at some point they're going to have to unwind that stuff. At some point, prices will start rising and banks, when they feel confident again, will start lending and so it's better to not have ten trillion dollars in excess reserves sitting there. It would be better to have just one trillion. The point is, even if you didn't think there was an issue, if everybody is kind of agreeing this isn't really working right now, it's not getting us where we need to be, then why would you just keep piling on?

WOODS: You know, new people are subscribing to this program all the time, and although a lot of people know about the Austrian theory of the business cycle, or they hear the term "boom-bust cycle" and they know what we're talking about, we probably should have a program for the average guy who's just diving into this for the first time, and have it be on Austrian business cycle theory. So maybe we'll have you or some other guest, because it really is the key to understanding so many other things.

Well, anyway, Bob, as always I appreciate your time. There's always so much idiocy to respond to, and yet I have Bob Murphy only twice a month. But I think we really packed a lot of good responses into this short amount of time. Thanks again.

MURPHY: Thanks for having me. See if you can get Larry Summers on. He can talk about Austrian business cycle theory.

WOODS: Or Krugman, who seems to know it so intimately, right?

MURPHY: Yeah.