APOPLITHORISMOSPHOBIA

MARK THORNTON

Apoplithorismosphobia (ay-pope-lit-horris-mos-foe-be-ah) is the fear of deflation.[1] Or, more correctly, the fear that an economy would "suffer" from falling prices, or a general decline in the prices of goods and services. It is a fear that has gripped some economists, journalists, and policymakers with a blinding strength as powerful as faith. Evidence seems to suggest that the phobia develops from the inability to understand the causes of the Great Depression and a more general failure to distinguish between what Bastiat called "the seen" (e.g., deflation) from "the unseen" (e.g., the causes of contraction and unemployment). Under the influence of this phobia, victims develop an unfounded faith in the ability of monetary and fiscal policy. In extreme cases it leads to the support of powerful policy "weapons" to combat deflation—the equivalent of using economic weapons of mass destruction. As shown in the case of Japan, this behavior is counterproductive and should be considered a danger to society. The purpose of this paper is to describe and diagnose this phobia and to present a treatment to counteract its effects.

The phobia seems to be largely limited to economists, journalists, and policymakers, although labor and business leaders also express similar views. Apparently it does not affect the general public, whose attitudes, views, and actions indicate that they are generally quite attracted to the idea of deflation, especially if the brisk business in places like Wal-Mart and Costco, retailers who specialize in cutting their costs and prices below their competition, is any indicator. In limited cases, members of the general public seem to even develop a fetish for the deflation phenomenon. Of course, there are many complaints about businesses like Wal-Mart and their price-cutting practices, but the complaints are largely unfounded or irrelevant, and are typically made by someone with an ax to grind (DeCoster and Edmonds 2003).

It seems odd that economists would find the idea of falling prices to be a bad thing. Likewise, it is peculiar that policymakers would fear deflation and be willing to take drastic measures to insure the so-called "defeat" of deflation. Policymakers and politicians, after all, would supposedly want the general public—their constituency—to experience the beneficial effects of falling prices over time. Lower prices create a gain of utility or satisfaction for consumers, who can either purchase more of a good or use the money saved to buy larger quantities of other goods. Deflation thus has the same effect as an increase in income.

MARK THORNTON is a senior fellow with the Mises Institute and book review editor of the *Quarterly Journal of Austrian Economics*. Suggestions and comments from Guido Hülsmann, David Laband, Robert Ekelund, and Paul Wicks were very helpful.

[1] I am grateful to Chris Motsiopoulos for his Greek translation of the word deflation.

THE QUARTERLY JOURNAL OF AUSTRIAN ECONOMICS VOL. 6, NO. 4 (WINTER 2003): 5–18

Even more puzzling is the fact that deflation, *per se*, is highly favorable to low-income groups and economists—despite their claims of scientific objectivity—are in general biased in favor of low-income groups and against high-income groups, capitalists, and entrepreneurs. An economy that is experiencing deflation or falling prices tends to be favorable to low-income groups because low-income individuals tend to spend a high proportion of their income on goods. Wage earners also benefit because wage rates tend to be relatively stable, increasing in real terms and thus providing greater purchasing power over time in a deflationary economy. Workers and business owners do not fear declining prices, they fear unemployment and recession, and these phenomena are not systematically related to deflation (Bordo and Redish 2003). Nonetheless, it is helpful to begin the analysis of the problem by showing that deflation is not a source of economic misery.

In Defense of Deflation

Since World War II and the rise of Keynesian economics, professional economists have understood the word deflation to mean a decrease in the index of consumer goods prices, and inflation to mean an increase in the same or similar index. Before this, the term deflation was defined as a decrease in the stock of money and inflation as an increase in the stock of money. One problem with defining deflation as the effect, i.e., price deflation, instead of the cause, i.e., monetary deflation, is that it can mislead economists from knowing the causes, effects, and proper policy approach to "deflation."

When discussing the value or purchasing power of money, we must realize that the "price" of money goes up and down for a variety of reasons related to the supply and demand for money, as well as public policy. Just as in the case of other prices, there are good reasons and bad reasons, and in the case of deflation there are four basic types of deflation, two of which are related to the demand for money and two of which are related to the supply of money.[2]

- An increase in savings, the accumulation of capital goods, and improved technology will all result in a greater production of goods, and with a given money stock will result in lower prices and a monetary unit of greater purchasing power. When nominal wages are stable, lower prices increase real wages to reflect the increase in the productivity of labor. Industries that expand productivity the most tend to accumulate the most profits. This *growth deflation* is a general pattern of industrial capitalism prior to the age of central banks and fiat money. It is also reflected today in industries that expand productivity faster than the rate of inflation, such as computers and consumer electronics. Salerno (2002a) finds this form of deflation to be entirely benign while Selgin (1997) demonstrates that it is efficient and beneficial to allow prices to fall in line with improvements in productivity.

- The demand for money could also increase for "exogenous" reasons, usually related to government policies that result in greatly reduced capital asset values, whereby individuals attempt to increase their cash balances. As money is withdrawn from circulation, the prices of goods fall, and the increased purchasing power of money allows the public to satisfy its increased "real" demand for money. This type of *cash-building*

[2]For a complete analysis see Salerno (2002a).

deflation is a natural reaction to the outbreak of war, civil war, or natural disaster. It also occurs with the onset of recessions, higher unemployment rates, stock market crashes, or even with widespread speculation that prices will fall in the near future. This phenomenon also happened in association with the Y2K bug because people wanted physical cash in case electronic transactions were temporarily disabled. A significant increase in the demand for money not coupled with such causal events is a rare, possibly unknown event. This type of deflation can either be viewed as benign or beneficial, but it is often characterized derisively as "hoarding." The problem associated with hoarding is not with deflation *per se*, but the exogenous factor that led to it, such as war. Hoarding is actually the solution to the problem, not the problem itself. Those who deride hoarding are usually the policymakers responsible for the real problem, people who have to reduce the price of their products in the face of decreased demand, or people who are not prepared for the exogenous event by their own failure to store extra "liquidity." Unemployment is often associated with hoarding, but this unemployment is related to either exogenous factors, such as natural disasters, or is the result of labor regulations that prevent nominal wages from adjusting.[3] Hoarding can also quicken an economy's descent into recession or even deepen the recession if prices are sticky.[4]

- The type of deflation feared the most is *bank credit deflation*, which often arises when depositors perceive a threat to their money during economic downturns. If a fractional reserve bank is perceived as having made highly speculative loans or of possessing too many nonperforming loans, depositors might seek to withdraw all of their demand deposits *en masse*. This "bank run" has the effect of getting depositors the largest percentage of their deposits in as quick a fashion as possible. The remaining assets of the bank can then be sold off to satisfy some of the remaining claims of depositors, but any remaining loss to depositors represents a contraction of the overall money supply. This contraction in turn would have some deflationary impact on prices. If depositors of all banks perceive the possibility of insolvency or illiquidity, then the

[3]The economic problem long associated with hoarding is described by Mises:

> The idea that hoarded money is a barren part of the total amount of wealth increase of which causes shrinkage in that part of wealth that is devoted to production is correct only to the extent that the rise in the monetary unit's purchasing power results in the employment of additional factors of production for the mining of gold and in the transfer of gold from industrial to monetary employment. (1998, pp. 519–20)

[4]In particular see the monetary equilibrium theorists of the Austrian School such as Selgin and White (1996), Selgin (1997), Sechrest (1993), and Horwitz (2000) who do find a problem in excess demands for money not accommodated by the monetary authority and suggest that true free banking could accommodate such swings in demand. Monetary disequilibrium theorists such as Yeager (1997) also present the economic costs involved in the process of deflation. Accommodating for significant increases in the demand for money (based solely on psychological factors) might prove worthwhile, if they ever did occur, but are ineffective and possibly counterproductive when addressing excess demands based on real factors. Given the known risks of having a "monetary authority," prudence suggests that likely costs outweigh the theoretical benefits.

attempt to withdraw deposits would result in a run on most banks, or a system-wide banking panic. In a bank panic many banks are forced into bankruptcy, there is a larger contraction of the money supply, and a significant deflation of prices. Bank panics can also temporarily disrupt the system of payments and prevent businesses from accessing capital. Given that real problems exist in the economy, e.g., recession, the bank panic is the quickest way to resolve the business errors and get the economy on the road to recovery and growth. However, the macroeconomic problems and related systemic problems of contagion can be avoided by having a completely decentralized and unregulated banking industry or a system in which banks are required by law to hold maximum reserves to cover demand deposits and any central monetary authority is not allowed to influence the money supply or interest rates. Historically, the long periods of economic depression and stagnation have occurred in the central banking era, while bank panics were somewhat frequent during the National Banking Act era and rarer during the so-called "free banking era" (1837–1860) when the majority of states passed laws that weakened their regulatory authority over banks and note issue. Apoplithorismosphobes generally believe that economies and/or their banking systems are inherently unstable.

- Another form of bank credit deflation is *confiscatory deflation* where the government steps in to prevent the bank panic from liquidating an unsound banking system during the bust phase of the boom-bust business cycle. This alternative has been used in Brazil, Ecuador, the former Soviet Union, and twice in Argentina. This approach seems to benefit the ruling elites and the owners of banks and hurts the general population of depositors, who only obtain their money after a long delay over which time its value has been greatly depreciated. In addition to the loss incurred by money owners, confiscatory deflation has negative effects on the ability of people to pay their bills, purchase goods, and to conduct their businesses. Ultimately, as in the case of Argentina, confiscatory deflation results not just in the breakdown of the economy, but of civil society, the democratic process, and the rule of law (Salerno 2002a, pp. 15–19; 2002b).

With the exception of confiscatory deflation, deflation *per se* should be viewed as an integral part of the economic process that helps the capitalist economy with destabilized money and credit systems adjust to both good phenomena, such as economic growth, and bad economic phenomena, such as war. Price deflation is an effect; it is part of the efficient workings of the market economy and the process of economic growth. Deflation is a solution to economic problems and an integral part of the process of economic recovery. The process of deflation, where the prices of goods, commodities, labor, and asset prices fall, is the process of economic recovery where labor and capital are reallocated. The fear of deflation is simply a confusion of cause and effect, whereby economists and politicians blame falling prices for the problems caused by prior increases in the quantity of money, widespread intervention in the economy, and political events such as war and revolution. Deflationary depressions are not independent events and the fact that the process of deflation can take place during some depressions and is associated with the quickening and deepening of some depressions is not an indictment of deflation, but of the original causes of those depressions and some of the wrongheaded policy cures used to address depression. Stock market bubbles don't "just happen," and to suggest otherwise, an economist is not presenting economic analysis, but his ignorance. Even at the beginning of the history of economic thought, Richard Cantillon (1755) showed deflation was a natural part of the economic process while economic booms and busts were the result of monetary intervention. Frédéric Bastiat (1801–1850) showed just how wrong and pernicious monetary expansion policies could be (Thornton 2002; Bastiat 2002).

Diagnosis: Doctrinal Disease

Dividing all economists into three distinct groups is a process that is fraught with error and mischaracterization and therefore no individual representatives will be singled out for identification. Nevertheless, economists will easily recognize the general characteristics of each group, which could be broadly described with labels such as Keynesian or Monetarist, and with the typical policy views you would expect to be presented in an interview, debate, or public lecture on topics such as monetary policy, deflation, or economic depression. While the phobia seems to afflict members of most schools of economic thought, the existence and severity of the disease seems to be correlated with an individual's views on monetary policy and theory. Obviously, not everyone in the schools of economic thought listed below is an apoplithorismosphobe.

By far the largest group both within and outside the economics profession could be broadly labeled as Keynesian. This diverse group includes the original Keynesians, post Keynesians, new Keynesians, Institutionalists, Historicists, Mercantilists, and various other radical and left-of-center groups. They argue, correctly, that money is a good thing. From this they then argue that money can solve many problems; that it can stimulate both employment and investment, and the stock of money can be increased, unlike physical goods, at nearly a zero cost. The monetary policy of the central bank should therefore be to keep interest rates as low and stable as possible. They think low, even zero, interest rates would reduce the propensity of people to save, thereby encouraging consumption while simultaneously stimulating investment. This group consists of people from groups such as bankers, Wall Street stockbrokers and analysts, the media, politicians, and a large percentage of the economics profession. Obviously there is a great deal of diversity of opinion within these groups in matters of methodology, theory, and policy. Nonetheless, there are hallmark characteristics that economists will recognize such as the propensity under most circumstances to advocate increasing the money supply and lowering the rate of interest.

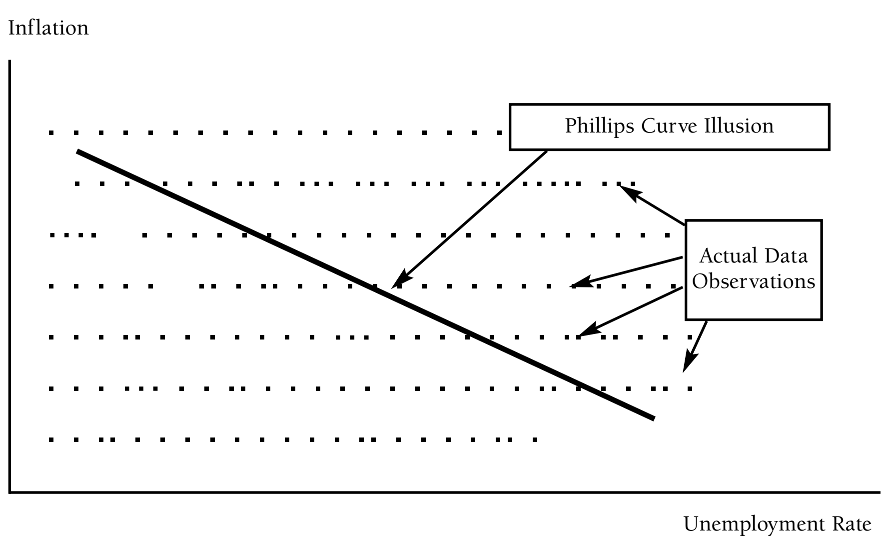
It should be noted that this group generally places monetary policy in a subordinate role to fiscal policy. However, the fact that money loses value erratically over time while following their policies is often viewed by factions within the group as either a bad but tolerable consequence, an unimportant issue, or even a positive outcome because it increases the "velocity" of money and thereby further encourages consumer demand. One test for the phobia in this group is to present a scatter diagram of historical data on inflation and unemployment, the economics equivalent of the Rorshach inkblot test, and ask what they see in the dots. A victim of the phobia will respond "the Phillips curve." See Figure 1 for a sample scatter diagram. Members of this group can also suffer from severe apoplithorismosphobia.

The second group also generally believes in political control of money and credit and that the money supply should be increased on a regular basis. However, they believe that there should be a more scientific basis for determining how much and how fast the money stock should be increased with the goal of stabilizing the purchasing power of money. This group could be broadly labeled as the Monetarists and would include the old Chicago School, Monetarists, supply-siders, monetary disequilibrium theorists, some classical economists such as Adam Smith and Karl Marx, some mercantilists such as Alexander Hamilton, and the infamous John Law. This group normally exhibits less fear of deflation and tends to place monetary policy in supremacy over fiscal policy. They tend to suffer from an obsession with a stable value or "just price" of money. This is also a diverse group, but they could be generally characterized as advocating policy designed to achieve a single set price of money. They fear both inflation and deflation equally, but recognize that the normal course of the capitalistic economy is growth and deflation; therefore they advocate increasing the stock of money over time. Some even feel so strongly about the stability of money's value that they advocate that their policy own views be raised to the level of a Constitutional amendment.

The zeal of this group is somewhat diminished by the fact that they have established more than one mutually exclusive standard for monetary policy. One would increase the stock of money by a given percentage each year. Devotees of this standard exhibit little external fear and claim not only that the economy is stable, but that it will stabilize more when the standard is exacted, and become even more stable over time. Different rates or ranges of rates of monetary growth are advocated by members of this group depending on their estimate of the long-run average growth rate of the economy. Some members of this group would advocate a standard that calls for the inflation rate to be targeted within a low narrow range, i.e., 1–3 percent.

A second standard would maintain the purchasing power of the monetary unit (the dollar) at its current level in perpetuity by increasing the money supply by the actual growth in the economy. Some would contend that if the monetary authority overshot the target or goal, they should not be required to undershoot in the subsequent period because of the fear of deflation. The fiercest defenders of stable money will tolerate deflationary deviances in order to offset inflationary mistakes. However, these standards face intractable practical problems in that (a) there is no practical method of precisely and accurately measuring the money stock or the purchasing power of money, and (b) even if policy were to proceed with the "advanced" methods at hand, policy directors still face the problem of changing behavior on the part of money holders and banks that result in changes in the demand for money. Even if all the problems of economic reality could be solved, policy would still be dependent on political control of the money supply, the trump card that makes these internecine

Figure 1
Scatter Diagram: Unemployment and Inflation, U.S. and U.K., 1776–1999
Hypothetical Data vs. Phillips Curve Illusion



debates superfluous. And while this group does not typically exhibit the outward signs of the phobia, and has in fact helped check the open psychosis of the Keynesians, it will, under adverse conditions (that every monetary "system" must endure), experience panic attacks similar to those experienced by the Keynesians and advocate irresponsible monetary policies.[5] While these two groups are easy to distinguish and debates between the two are well worn, in reality there is diversity within the groups and an entire spectrum of policy views. Indeed, both groups even have a shared intellectual heritage (Davis 1968; Patinkin 1969).

Even a basic understanding of the business cycle and the causes of recession would do much to combat the fear of deflation. So it is not surprising that in addition to problems in monetary theory and policy, the sufferers of apoplithorismosphobia also tend to lack a well-developed sense of what causes business cycles and asset-price bubbles. This was recently demonstrated at a conference sponsored by the World Bank and the Chicago Fed featuring some of the leading economists of the first two groups. What causes asset-price bubbles? Do they lead to deflation, and what can be done about them? These were the questions posed. Randall Kroszner of the University of Chicago and the President's Council of Economic Advisors said the uncertainty about the past makes real-time identification of bubbles problematic. "The research record on asset-price measurement is far from being sufficient to build a policymaker's confidence." The Governor of the Bank of France, Jean-Claude Trichet, said that determining asset-price bubbles was difficult and even if targeted would do more harm than good because people "may become involved in riskier projects without having consciously taken the decision to accept greater risk."

Fredrick Mishkin and Eugene White re-examined the last 100 years of stock market crashes and suggested that ignoring stock market crashes and concentrating on the economy is a better policy to follow in order to avoid severe financial meltdown, at least most of the time. Kunio Okina and Shigenori Shiratsuka found that the Bank of Japan should have used aggressive monetary policy following the Japanese bubble, but could not do so due to the fundamental and ongoing weakness of the Japanese banking and financial system. Santiago Herrera and Guillermo Perry suggested an exogenous factor played an important role in some bubbles, namely that the United States helped export bubbles to Latin American economies.

Are bubbles "rational"? John Cochrane of the University of Chicago thinks bubbles are rational in that holding shares of high-tech companies is like holding cash. Ellen McGrattan and Edward C. Prescott of the Federal Reserve Bank of Minneapolis found that there really was not a bubble in 1929 and that stocks were actually undervalued. The august Allan Meltzer of Carnegie Mellon University made the reassuring claims that bubbles could be explained, that buyers and sellers during bubbles are rational, and that "expansive economic policies can compensate for *any* deflationary impulse on output prices coming from asset prices." Werner De Bondt, however, felt that psychological factors played an important role in problems such as short-term overconfidence, lack of diversification, chasing winners, and overtrading. Michael Bordo and Antu Murshid found that bubbles are transmitted regionally during some periods and internationally during others. Franklin Allen and Douglas Gale found that international stock linkages can either increase or decrease the extent of asset

[5]In response to the problems of deflation in Japan several members of the monetarist group including Milton Friedman and Ben Bernake calmly stated that the central bank should simply print up unlimited amounts of money, that the bank threaten consumers (who are hoarding their own money) with ever-increasing levels of inflation, or that the central bank purchase worthless stocks, corporate bonds, real estate and even directly fund government expenditures. They blithely add that it (i.e., deflation) could never happen here (i.e., the U.S.).

bubbles. Steven Kaplan of the University of Chicago found that high-tech stocks were highly valued because people felt they would reduce transactions costs, but stock market values fell when people no longer felt that way. Marvin Goodfriend of the Federal Reserve Bank of Richmond said that central banks should not target asset prices, but Michael Bussa of the Institute for International Economics said they should, sometimes. Stephen Cecchetti and Hans Genberg argued that it might help to target asset prices. There was agreement that if asset bubbles do exist, then they are inevitable, whether they are rational or not (Hunter, Kaufman, and Pomerleano 2003).

Doctrinal Defense

The final group consists of those who do not suffer much from apoplithorismosphobia. This is a very small group within the affected groups—so small in number, in fact, that one would have to go back 250 years to collect enough adherents among economists to have a decent-sized cocktail party. This group would consist of Richard Cantillon, A.R.J. Turgot, some of the physiocrats and classical economists, Frédéric Bastiat, William H. Hutt, P.R. Brahmananda, and many members of the modern Austrian School of economics. If the first group, the Keynesians, could be labeled "inflationist" and the second group, the Monetarists, could be called the "stabilizationists," then the third group could be loosely described as the Austrians, and be labeled the "deflationists."

More correctly, this group does not advocate deflation; it simply doesn't fear it. In fact, it really does not advocate any particular quantitative change in the money stock, or any particular stock of money, or any particular value of money. It generally believes that any stock of money is sufficient to serve as the medium of exchange. And even those of the group who feel that certain types of deflation need to be addressed do not seem to "fear" deflation. Most members of this group do advocate an important qualitative change in the supply of money whereby the government would no longer be involved with the supply of money, and whereby the stock of money and its value would be determined by market forces rather than by government, politics, or bureaucratic decrees. Based on the notion that people would resort, as they did resort, to commodity monies such as gold, members of this group generally believe that increases in the demand for money would tend to exceed increases in the money stock over time, just as it had done in the past. The result would be a trend toward an increasing purchasing power of money, or mild deflation of prices.

If changes in the purchasing power of money became too erratic, other than reactions to real world events such as war, natural disasters, and political revolutions, then the "market" would turn to substitute monies. For example, if the supply of or demand for animal-based money, such as cows, was too unstable due to animal diseases or the development of large-scale meat-eating festivals, the market might switch to vegetation-based monies, such as tobacco. If that money was in turn destabilized by erratic agricultural output or tobacco dropping out of common use, the market could switch to metallic money such as gold or silver. But this group believes that real shocks to the economy like crop failures and wars, as well as real shocks in the demand and supply of money, should be allowed to work themselves out in the market, without government intervention, and that these changes should be reflected in the price, value, or purchasing power of money. A free banking system could easily adjust to seasonal, secular, and technological change.

Should a large negative event, such as an invasion, be allowed to result in an increase in the value of money? Should a new technological discovery that reduces the cost of mining and processing gold be allowed to reduce the value of money significantly? Deflationists would answer yes.

Acute Apoplithorismosphobia: The Case of Paul Krugman

Nowhere is the fear of deflation stronger than in the person of Paul Krugman, editorial writer for the *New York Times* and an economist at Princeton University. The evidence suggests that his fear of deflation is based on the association of deflation and depression, especially the Great Depression, and more recently on the case of the Japanese economy since 1990. It seems that Krugman has an unsettled view of what causes either phenomenon or the causal link between the two. He is clearly afraid of their combination, although he claims that "the only thing we have to fear is fear itself." His fear of deflation and depression leads him to advocate policies that are known to cause recessions and depressions.

Krugman firmly supports the demand-side approach of Keynesian economics where demand can falter because of psychology and Keynes's "animal spirits." There is no real cause of depressions or recessions, they just start, and "for whatever reason, the economy becomes depressed" (Krugman 2002d). He notes with Lucas (1987) that "the Great Depression had no obvious cause at all" (Krugman 2001).

Krugman observes that Japan has experienced deflation, stagnation, or low levels of inflation and economic growth for more than a decade. It seems to Krugman that deflation "turned out to be something that can happen here" and "that monsters from the 1930s were once again walking on earth." He likens this process to falling into a black hole of space, noting that:

> the economy crosses the black hole's event horizon: the point of no return, beyond which deflation feeds on itself. Prices fall in the face of excess capacity; businesses and individuals become reluctant to borrow, because falling prices raise the real burden of repayment; with spending sluggish, the economy becomes increasingly depressed, and prices fall all the faster. (Krugman 2002d)

Indeed the "threat of deflation is worse now than it was a year ago," and he notes "that by some measures deflation is already here," "that we've moved closer to the event horizon," and even that "the pull of the black hole is increasing." With images of monsters and black holes, Krugman falls into the gibber-jabber of sophomoric circular reasoning:

> If you think about this a bit, the story gets even worse. After all, prices are falling because the economy is depressed; now we've just learned that the economy is depressed because prices are falling. That sets the stage for the return of another monster we haven't seen since the 1930's, a "deflationary spiral," in which falling prices and a slumping economy feed on each other, plunging the economy into the abyss. It's pretty scary stuff, not just for Japan but for the rest of us. If Japan slides into the abyss, that will have a direct adverse effect on our economy dwarfing anything the terrorists did. (Krugman 2002d)

In this state of high anxiety, what do we do? How do we combat this depression? Normally, mainstream economists would recommend monetary and fiscal policy measures to "stimulate" the economy, such as increasing the money supply, reducing interest rates, increasing government spending, and running a government budget deficit. However, Krugman notes that these measures have all been tried and have not worked in Japan. The Japanese central bank, the Bank of Japan, has already reduced the interest rate on short-term government securities to practically zero and the Japanese government has undertaken public works and spending programs not seen since the building of the pyramids, all without any positive effect on the economy. While in a general state of dismay, Krugman can still look to the bright side and demonstrate his obvious taste for big government while describing the public works programs in Japan:

> Think of it as the W.P.A. on steroids. Over the past decade Japan has used enormous public works projects as a way to create jobs and pump money into the economy. The statistics are awesome. In 1996 Japan's public works spending, as a share of G.D.P., was more than four times that of the United States. Japan poured as much concrete as we did, though it has a little less than half our population and 4 percent of our land area. One Japanese worker in 10 was employed in the construction industry, far more than in other advanced countries. (Krugman 2001)

The only problem is that all this government spending did not get the Japanese economy out of stagnation, but it did prevent, according to Krugman, the economy from "sliding into a true, unambiguous depression." He laments that public works projects only provide "temporary, symptomatic economic relief" and do not provide "the basis for a permanent turnaround." Worse still, these massive public works projects have "produced nasty side effects. One is the vast environmental damage that has been inflicted in the name of job creation. Another is pervasive corruption, as rake-offs and kickbacks have become a way of life, distorting the whole economic and political system." In addition to undermining democracy and making corruption a way of life in Japan, these projects have been financed by massive government borrowing, changing Japan from a relatively fiscally prudent government to a fiscal spendthrift whose credit rating is being reduced.

> The years of deficit spending since then have pushed Japan's debt above 130 percent of GDP. That's the highest ratio among advanced nations, considerably worse than either Belgium or Italy, the traditional champions. It's almost twice the advanced-country average and 2.5 times the figure for the United States. (Krugman 2001)

Japan has tried the traditional measures of monetary and fiscal policy stimulus and has tried them in extreme fashion, and all have failed.[6]

What then can Krugman offer as a remedy? His answer is to go beyond the normal limits of government economic policy, to go where no government has gone before. He recommends the following policies for the Bank of Japan (Krugman 2001):

- Use reserves to buy "anything other" than short-term government debt, possibly corporate stocks and bonds.
- Buy long-term government securities and thereby drive down long-term interest rates.
- The Bank of Japan should print yen and use them to buy dollars, thus making Japanese exports easier to sell on world markets.
- Announce a policy of inflation targeting that guarantees the market at least 2.5 percent inflation per year.

Krugman writes that in the past these policy ideas have been considered radical, irresponsible, and beyond the traditional limits of financial prudence. However, in light of all the fear over possible deflation and depression, they "have since become respectable, almost mainstream." And that is a good thing, Krugman councils,

[6]For a proper analysis of Japan's economic problems see Herbener (1995) and Powell (2002).

because while we are not in deflation, we must be prepared and above all, we must not be afraid to use extreme measures to snuff out deflation and depression before it gets started (Krugman 2001). "The time to fight deflation is before it has time to get built into the nation's psychology" (Krugman 2002a). For Krugman, the business cycle is a psychological problem and it requires a psychological remedy.

But here, Krugman is the patient, not the doctor. It is Krugman who is apparently suffering from an obsessive fear and it is this fear that causes him to commit illogical analysis (from a classical economics perspective), to come to irrational conclusions, and to recommend policies that will only make his fears more likely to turn into reality. In more sober moments, Krugman shows that he can fight this phobia and produce sound economic analysis and critical commentary. For example, Krugman responded forcefully and critically to Alan Greenspan's claims that he could not have known about the bubble in the stock market until after it had burst, and that even if he did know, there was nothing that the Fed could do to stop it anyway (Krugman 2002c). And in an article, "Mind the Gap," Krugman writes as if he is in therapy: "Back when I first got professionally obsessed with Japan's problems, around four years ago." His analysis is forceful and to the point: "There's no mystery about the causes of our funk: the bubble years left us with too much capacity, too much debt and a backlog of business scandal. We shouldn't have expected a quick and easy recovery, and we're not getting one" (Krugman 2002b). This clarity of thought is unfortunately rare in his writings and policy recommendations.

Babysitter Economics

Paul Krugman uses a "model" economy based on the experience of a babysitting co-op in Georgetown to describe and diagnose macroeconomic maladies (Sweeny and Sweeny 1977). Members of the co-op pay and receive one unit of script for one unit of babysitting, but Krugman claims that the co-op experienced an increase demand to hold babysitting tickets, the same thing as a deficiency of aggregate demand, and that the co-op went into recession. His solution to this "recession" is to print up more script and hand it out to members, i.e., inflation. In the real world "recession is normally a matter of the public as a whole trying to accumulate cash" and likewise Krugman declares inflation the solution (Krugman 1999). For Krugman, financial breakdowns in Latin America and Asia were simply a matter of insufficient aggregate demand.

The model is too simplistic to explain or illustrate recession, and it is near fraud to base real-world analysis on such a flimsy foundation. In the economy of the co-op there is a single, homogeneous good, babysitting, while the real world is characterized by an ever-increasing heterogeneity of goods. In the co-op economy the only input is labor, but in business cycle economics and history, things like credit, capital, investment, technology, debt, and bankruptcy are the primary issues, and even in labor-based business cycle theories, the main story is always that labor is attached or detached to capital goods. The most basic economic point is that the co-op has only one fixed price and prices are not allowed to adjust due to the bylaws of the co-op. As the authors of the original paper state, "The script-price of babysitting couldn't adjust, and the shortage worsened" (Sweeny and Sweeny 1977, p. 87). But Krugman does not even bring up the issue of prices, nor does he discuss the price adjustment that eliminates shortages and surpluses in the market economy. Likewise, in the case of the economic meltdowns in Asia and Latin America, he does not bring up the issue of what caused the problems; the unfettered free market just goes bad. In fact, in both Asia and Latin America, the economies were subjected to high, double-digit rates of monetary inflation in the years before the crisis. Like an alcoholic recovering from a five-year bender, Krugman is right there to suggest that another couple of cases of whiskey should get rid of that hangover and get you on the road to recovery.

The babysitter model appears in a four-page comment where the co-authors place their tongues firmly in their cheeks. There have been no citations to the four-page paper since it was published in 1977, as indexed by the Institute for Scientific Information, the most comprehensive source of citations, which reviews over 7,000 sources for citations.[7] You could say that the article was largely written and read "just for fun," and at the end of the article the authors are careful to issue a clear message of caution for the reader to not read too much into the paper, and an explicit cautionary statement to guard against the type of recommendations that Paul Krugman is so famous for making:

> Now, if goodhearted people in an area that offers little scope for chicanery can so bungle economic management (the babysitter co-op), can we really be surprised at the results of turning our economy over to the tender mercies of political experts? Indeed, unlike the co-op, the national economy seems virtually indestructible, not having died yet. (Sweeny and Sweeny 1977, p. 89)

In other words, resist the fairy tales of consultants and pundits, like Paul Krugman, who offer "economic management" of the economy as a panacea when in fact national economies are best left to their own devices.[8]

12-Step Program for Apoplithorismosphobes

In order to recover from apoplithorismosphobia it is recommended that patients follow this 12-step program:

1. Revisit and relearn the basic principles of economic analysis, such as supply and demand.
2. Remember that the cause of misallocations and unemployment is government interventions, such as price controls, inflation, and regulations.
3. Re-examine the effects of monetary policy, other than on the price level.
4. Stop thinking about the price level.
5. Pay less attention to statistics in general.
6. Forget modern macro[9] altogether.
7. Note that macroeconomic problems are usually preceeded by large increases of the money supply (i.e., inflation).
8. Remember that the Great Depression occurred after central banks were established, not before.
9. Remember the Fed's "mistakes" took place well after the Great Depression began.

[7]ISI does not index books, newspapers, and some journals.

[8]For further analysis of Krugman's book see Ritenour (2000).

[9]In recent times, macroeconomics, or the study of the overall economy, is often referred to as modern macro, presumably because it no longer contains any economics.

10. Recall that Herbert Hoover and FDR (and modern Japan) pursued activist policy regimes to keep wages and prices high.
11. Remember that monetary and fiscal policy do not cure recessions or prevent deflation; they only exacerbate the problems and delay recovery.
12. Remember that some of the best periods of economic improvement in human history have occurred during deflations.

Economists seem doomed to repeat the mistakes of the past due in large part to the irrational fear of deflation. If they would follow the above 12-step program they could break the vicious cycle of fear and confusion and achieve clarity of economic thought.

References

Bastiat, Frédéric. 2002. "What is Money?" *Quarterly Journal of Austrian Economics* 5 (3): 87–105.

Bordo, Michael D., and Angela Redish. 2003. "Is Deflation Depressing? Evidence from the Classical Gold Standard." NBER Working Paper No. W9520. National Bureau of Economic Research (March).

Cantillon, Richard. [1755] 2001. *An Essay on the Nature of Commerce in General*. New Brunswick, N.J.: Transaction Publishers.

DeCoster, Karen, and Brad Edmonds. 2003. "The Case for Wal-Mart." Http://www.mises.org. Daily Articles (January 31).

Davis, J. Ronnie. 1968. "Chicago Economists, Deficit Budgets, and the Early 1930s." *American Economic Review* 58 (3): 476–81.

Herbener, Jeffrey. 1995. "Goodbye Japanese Miracle." *Free Market* 13 (11).

Horwitz, Steven. 2000. *Microfoundations and Macroeconomics: An Austrian Perspective*. New York: Routledge.

Hunter, William C., George G. Kaufman, and Michael Pomerleano, eds. 2003. *Asset Price Bubbles: The Implications for Monetary, Regulatory, and International Policies*. Boston: MIT Press.

Krugman, Paul. 2002a. "Living With Bears." *New York Times* (July 23).

——. 2002b. "Mind the Gap." *New York Times* (August 16).

——. 2002c. "Passing the Buck." *New York Times* (September 3).

——. 2002d. "Crisis in Prices." *New York Times* (December 31).

——. 2001. "Fear Itself." *New York Times* (September 30).

——. 1999. *The Return of Depression Economics*. New York: W.W. Norton.

Lucas, Robert E., Jr. 1987. *Models of Business Cycles*. New York: Basil Blackwell.

Mises, Ludwig von. 1998. *Human Action: A Treatise on Economics*. Auburn, Ala.: Ludwig von Mises Institute.

Patinkin, Don. 1969. "The Chicago Tradition, the Quantity Theory, and Friedman." *Journal of Money, Credit and Banking* 1 (1): 46–70.

Powell, Benjamin. 2002. "Explaining Japan's Recession." *Quarterly Journal of Austrian Economics* 5 (2): 35–50.

Ritenour, Shawn. 2000. A Review of "Post Modern Economics: The Return of Depression Economics." *Quarterly Journal of Austrian Economics* 3 (1): 79-83.

Sechrest, Larry J. 1993. *Free Banking: Theory, History, and a Laissez-Faire Model*. Westport, Conn.: Quorum Books.

Salerno, Joseph, T. 2002a. "An Austrian Taxonomy of Deflation." Paper presented at the conference "Boom, Bust, and the Future" (January 19), Auburn, Alabama.

——. 2002b. "Confiscatory Deflation: The Case of Argentina." Http://www.mises.org. Daily Articles (February 13).

Selgin, George. 1997. "Less Than Zero: The Case for a Falling Price Level in a Growing Economy." IEA Hobart Paper No. 132. London: Institute of Economic Affairs.

Selgin, George, and Larry H. White. 1996. "In Defense of Fiduciary Media—or, We are Not Devo(lutionists), We are Misesians." *Review of Austrian Economics* 9 (2): 83–107.

Sweeny, Joan, and Richard James Sweeny. 1977. "Monetary Theory and the Great Capital Hill Baby-sitting Co-op Crisis." *Journal of Money, Credit and Banking* 9 (1): 86–89.

Thornton, Mark. 2002. "Frédéric Bastiat's Views on the Nature of Money." *Quarterly Journal of Austrian Economics* 5 (3): 81–86.

Yeager, Leland B. 1997. *The Fluttering Veil: Essays on Monetary Disequilibrium*. George Selgin, ed. Indianapolis, Ind.: Liberty Fund.