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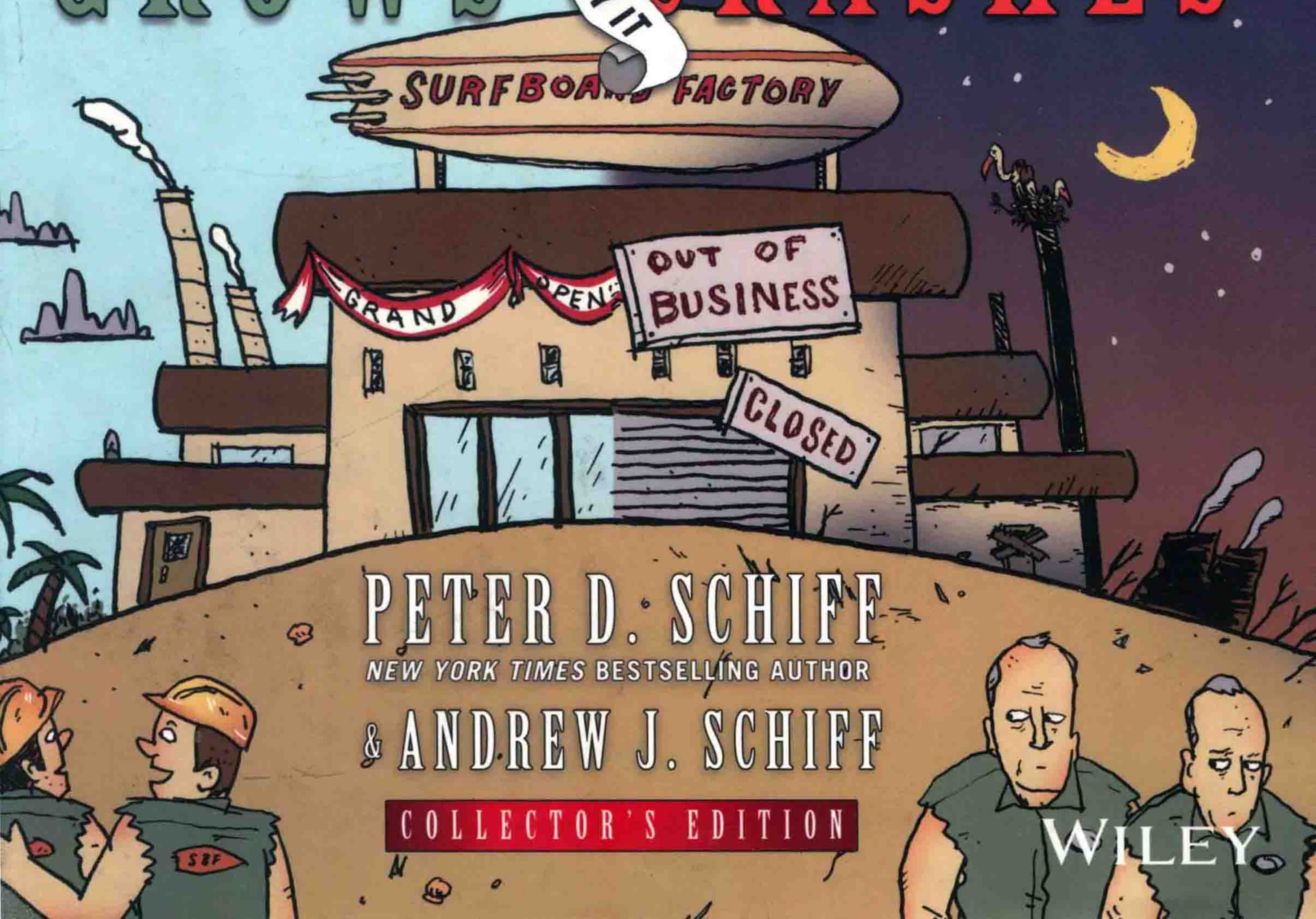
HOW AN ECONOMY GROWS AND WHY IT CRASHES



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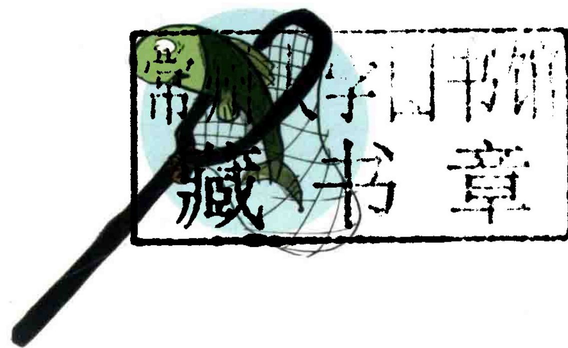
NEW YORK TIMES BESTSELLING AUTHOR
& ANDREW J. SCHIFF

COLLECTOR'S EDITION

WILEY

How an ECONOMY GROWS and Why It CRASHES

Collector's Edition



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To my father Irwin Schiff and fathers everywhere, who tell stories to their sons, and to my sons Spencer and Preston and sons everywhere, who pass them on to subsequent generations.

—Peter

To Irwin for the logic, Ellen for the care and support, Ethan for the enthusiasm, Eliza for the wonder, and Paxton for the home (maybe one day we'll get the hearth).

—Andrew

Disclosure

In addition to being the president, Peter Schiff is also a registered representative and owner of Euro Pacific Capital, Inc. (Euro Pacific). In addition to his duties as director of communications, Andrew Schiff is also a stockbroker at the firm. Euro Pacific is a FINRA registered Broker-Dealer and a member of the Securities Investor Protection Corporation (SIPC). This book has been prepared solely for informational purposes, and it is not an offer to buy or sell, or a solicitation to buy or sell, any security or instrument, or to participate in any particular trading strategy.

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Author's Note

In this allegory of U.S. economic history the reader will encounter many recognizable personalities and events. But as a very broad brush was needed to condense such a complex story into a cartoon book, many details have been blended.

In addition to the exploits of specific historical figures, characters represent broader ideas. For instance, while Brent Barnacle is clearly our version of Fed Chairman Ben Bernanke, Barnacle's actions in the story are not meant to solely apply to Bernanke himself. Rather, he is a representative of all highly inflationary economists.

In real life, Federal Reserve Notes were introduced 20 years before the election of Franklin D. Roosevelt. But given his penchant for spending, we decided to credit him with the innovation. And although Chris Dodd was but a child when Fannie Mae was actually created, his support of the agency in later years gives him originator status in our story. And, although the foreign islands in the book roughly correspond with actual countries, they are also stand-ins for all nations.

We ask that you forgive us these, and other, liberties of chronology and biography.

Introduction to the Collector's Edition

In the four years since we wrote the first edition of *How an Economy Grows and Why it Crashes*, we have had countless conversations with readers about how the book has been brought into their backyard discussions about our country and its shaky economy. That is what we hoped it would accomplish. But we do believe that we have some unfinished business.

The original book was certainly long on humor, content, and fish puns, but unfortunately it was a bit short on production quality. That was somewhat intentional. We wanted to keep the price low so that the book could find a large audience that had never been exposed to its simple lessons. But now we believe that many of our loyal devotees would appreciate a version with higher attention to visual detail. In particular, if the book is to be gifted, or to be placed upon coffee tables as a statement, then we wanted to make it a gift worth giving, and an object worth displaying.

And so we decided to put together a "Collector's Edition" that is bigger and more colorful than the original. We spiffed up the title pages, added a bunch of new graphics, and upgraded the paper stock from rough pulp to smooth and glossy. Basically, we switched to the storybook format that we always thought was consistent with the book's spirit. But that is just the packaging; we also added important content.

The original book was written just about one year after the economy almost completely collapsed. Since that time, things have apparently turned around. We are no longer reporting negative GDP growth, the

housing market has rebounded (with prices in some markets rising at record pace), the stock market is hitting record highs, inflation appears to be under control, and unemployment has drifted steadily downward. But at the same time, most Americans aren't feeling particularly good about the so-called "recovery."

Adjusted for inflation, median household income in August 2013 is lower than it was before the Great Recession began in 2008. More people are dropping out of the labor force or taking only part-time jobs when they really want full-time work. And the full-time jobs that are being created are more likely to be low-paying retail or service-sector jobs rather than the good middle-class jobs that are being lost. Today's college graduates are facing the bleakest employment prospects on record, even while they are leaving school with record amounts of debt.

As a society, we are traveling and vacationing less and spending more of our take-home pay on the basic necessities of life (food and energy). It is no accident that the cars currently on American roads are the oldest fleet on record, and that Detroit, a city that once represented the pinnacle of America's economic might, is now bankrupt.

There is a clear disconnect between the recovering economy that we are told we have and the disappointing prospects we are actually facing. That's because, in an effort to prevent further pain after the crash of 2008, the federal government began spending trillions of dollars that we didn't have, and the Federal Reserve began implementing a new policy called "quantitative easing" (QE). These policies have become a substitute for a real economy.

A decade ago, hardly anyone outside of university economics departments had heard of the phrase "quantitative easing." Today this policy has become the most important driver of the economy. Investors and financial journalists follow the Fed's statements about

QE as obsessively as 14-year-old schoolgirls follow the tweets of their favorite boy bands. It's as if Ben Bernanke has become Justin Bieber.

But QE is just a fancy euphemism for "printing money." Since 2010, the Fed has simply been creating trillions of dollars out of thin air and using them to buy assets like government- and mortgage-backed bonds. These actions have helped to push up prices in those markets and to lower long-term interest rates. The Fed is using the power of the printing press to create the illusion of recovery. But the economy it has created is only as real as the printing-press money propping it up. Beneath the thin facade of health lies an economy that's even sicker than it was before the Fed began administering its cure.

For instance, at the time we are preparing this new edition of *How an Economy Grows and Why it Crashes*, the Fed is buying $45 billion per month of Treasury debt, which is a majority of all the bonds that the government issues. This keeps long-term interest rates low, which then gooses the economy in a number of ways. It encourages business and individuals to borrow, and discourages them from saving. Ultra-low interest rates are also a primary reason that the stock market has taken off in recent years. If the Fed were to stop buying bonds, interest rates would immediately spike upwards, stocks would fall, and our apparent economic health would disappear.

QE has also made a direct impact on the housing renaissance. Through its purchases of $40 billion per month of mortgage-backed bonds, the Fed has essentially underwritten the housing market. But it is buying mortgages that private buyers, for good reason, don't want to touch. Housing prices are still too high relative to incomes, and most home buyers don't have enough saved for significant down payments. But government guarantors only require minimal down payments, and extremely low interest rates, supplied by the Fed, are keeping payments affordable. If these props were removed, the housing market would crumble as surely as it did in 2008.

As a result, it's not too much of a stretch to say that QE has become the lifeblood of our economy. The problem is that it is addictive and ultimately toxic. Rather than laying the foundation for a real recovery, we have achieved a QE-based artificial recovery that can only last as long as the QE does.

Currently, mainstream economists debate when and how the Fed will succeed in stopping the QE without damaging the economy (known as the "exit strategy"). While most concede that pulling off the exit strategy will be a difficult maneuver, they are confident that a highly skilled practitioner can pull it off with extreme dexterity and precision. This is like the old magician's trick of yanking a tablecloth from underneath a fully set table without upsetting the china. But that is not the trick the Fed is going to have to perform. In reality, it's not the tablecloth the Fed must yank away . . . but the table itself. They hope to do this without letting the cloth, and the dishes, crash to the floor.

That's why we believe our economy is now stuck in a trap. We are addicted to QE but we don't realize it. The QE exit strategy that economists are waiting for will never arrive. This is a one-way street that can only lead to more economic pain.

Given these new developments we have added two new chapters—17 and 18—that seek to demystify QE (as well as the more recent developments in the European debt crisis). We have also made a few edits throughout the book, and added some bonus content as well. We hope that they make the story even more relevant to our world as it exists in the fall of 2013.

So enjoy the book and share it with those in need of a dose of sanity.

—Peter and Andrew Schiff, September 2013

Introduction

Over the past century or so, academics have presented mankind with spectacular scientific advancements in just about all fields of study . . . except one.

Armed with a mastery of mathematics and physics, scientists sent a spacecraft hundreds of millions of miles to parachute to the surface of one of Saturn's moons. But the practitioners of the "dismal" science of economics can't point to a similar record of achievement.

If NASA engineers had shown the same level of forecasting skill as our top economists, the Cassini mission would have had a very different outcome. Not only would the satellite have missed its orbit of Saturn, but in all likelihood the rocket would have turned downward on lift-off, bored though the Earth's crust, and exploded somewhere deep in the magma.

In 2007 when the world was staring into the teeth of the biggest economic catastrophe in three generations, very few economists had any idea that there was any trouble lurking on the horizon. Years after the mess began economists continue to offer remedies that strike most people as frankly ridiculous. We are told that we must go deeper into debt to fix our debt crisis, and that we must spend in order to prosper. The reason their vision was so poor then, and their solutions so counterintuitive now, is that few have any idea how their science actually works.

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The disconnect results from the nearly universal acceptance of the theories of John Maynard Keynes, a very smart early-twentieth century English academic who developed some very stupid ideas about what makes economies grow. Essentially Keynes managed to pull off one the neatest tricks imaginable: he made something simple seem to be hopelessly complex.

In Keynes's time, physicists were first grappling with the concept of quantum mechanics, which, among other things, imagined a cosmos governed by two entirely different sets of physical laws: one for very small particles, like protons and electrons, and another for everything else. Perhaps sensing that the boring study of economics needed a fresh shot in the arm, Keynes proposed a similar world view in which one set of economic laws came in to play at the micro level (concerning the realm of individuals and families) and another set at the macro level (concerning nations and governments).

Keynes's work came at the tail end of the most expansive economic period in the history of the world. Economically speaking, the nineteenth and early twentieth century produced unprecedented growth of productive capacity and living standards in the Western world. The epicenter of this boom was the freewheeling capitalism of the United States, a country notable in its preference for individual rights and limited government.

But the decentralizing elements inherent in free market capitalism threatened the rigid power structures still in place throughout much of the world. In addition, capitalistic expansion did come with some visible extremes of wealth and poverty, causing some social scientists and progressives to seek what they believed was a more equitable alternative. In his quest to bring the guidance of modern science to the seemingly unfair marketplace, Keynes unwittingly gave cover to central authorities and social utopians who believed that economic activity could be better if planned from above.

At the core of his view was the idea that governments could smooth out the volatility of free markets by expanding the supply of money and running large budget deficits when times were tough.

When they first burst onto the scene in the 1920s and 1930s, the disciples of Keynes (called Keynesians), came into conflict with the "Austrian School" which followed the views of economists such as Ludwig von Mises. The Austrians argued that recessions are necessary to compensate for unwise decisions made during the booms that always precede the busts. Austrians believe that the booms are created in the first place by the false signals sent to businesses when governments "stimulate" economies with low interest rates.

So whereas the Keynesians look to mitigate the busts, Austrians look to prevent artificial booms. In the economic showdown that followed, the Keynesians had a key advantage.

Because it offers the hope of pain-free solutions, Keynesianism was an instant hit with politicians. By promising to increase employment and boost growth without raising taxes or cutting government services, the policies advocated by Keynes were the economic equivalent of miracle weight-loss programs that require no dieting or exercise. While irrational, such hopes are nevertheless soothing, and are a definite attraction on the campaign trail.

Keynesianism permits governments to pretend that they have the power to raise living standards with the whir of a printing press. As a consequence of their pro-government bias, Keynesians were much more likely than Austrians to receive the highest government economic appointments. Universities that produced finance ministers and Treasury secretaries obviously acquired more prestige than universities that did not. Inevitably economics departments began to favor professors who supported those ideas. Austrians were increasingly relegated to the margins.

Similarly, large financial institutions, the other major employers of economists, have an equal affinity for Keynesian dogma. Large banks and investment firms are more profitable in the Keynesian environment of easy money and loose credit. The belief that government policy should backstop investments also helps financial firms pry open the pocketbooks of skittish investors. As a result, they are more likely to hire those economists who support such a worldview.

With such glaring advantages over their stuffy rivals, a self-fulfilling mutual admiration society soon produced a corps of top economists inbred with a loyalty to Keynesian principles.

These analysts take it as gospel that Keynesian policies were responsible for ending the Great Depression. Many have argued that without the stimuli provided by government (including expenditures necessary to wage the Second World War), we would never have recovered from the economic abyss. Absent from this analysis is the fact that the Depression was the longest and most severe downturn in modern history and the first that was ever dealt with using the full range of Keynesian policy tools. Whether these interventions were the cause or the cure of the Depression is apparently a debate that no serious "economist" ever thought was worth having.

With Keynesians in firm control of economics departments, financial ministries, and investment banks, it's as if we have entrusted astrologers instead of astronomers to calculate orbital velocities of celestial bodies. (Yes, the satellite crashed into an asteroid, but the unexpected encounter could lead to enticing possibilities!)

The tragicomic aspect of the situation is that no matter how often these economists completely flub their missions, no matter how many rockets explode on the launchpad, no one of consequence ever questions their models.

Most ordinary people have come to justifiably feel that economists don't know what they are talking about. But most assume that they are clueless because the field itself is so vast, murky, and illogical that true predictive power is beyond even the best and most educated minds.

But what if we told you that the economic duality proposed by Keynes doesn't exist? What if economics is much simpler than that? What if what is good for the goose is good for the gander? What if it were equally impossible for a family, or a nation, to spend its way to prosperity?

Many people who are familiar with my accurate forecasting of the economic crash of 2008 like to credit my intelligence as the source of my vision. I can assure you that I am no smarter than most of the economists who couldn't see an asset bubble if it spent a month in their living room. What I do have is a fundamental understanding of the basic principles of economics.

I have that advantage because as a child my father provided me with the basic tool kit I needed to cut through the economic clutter. The tools came to me in the form of stories, allegories, and thought experiments. One of those stories serves as the basis for this book.

Irwin Schiff has become a figure of some renown and is most associated with the national movement to resist the federal income tax. For more than 35 years he has challenged, often obsessively, the methods of the Internal Revenue Service while maintaining that the income tax is enforced in violation of the Constitution's three taxing clauses, the 16th Amendment, and the revenue laws themselves. He has written many books on the subject and has openly challenged the federal government in court. For these activities, he continues to pay a heavy personal price. At 86 he remains incarcerated in federal prison.

But before he turned his attention to taxes, Irwin Schiff made a name for himself as an economist.

He was born in 1928 in New Haven, Connecticut, the eighth child of a lower-middle-class immigrant family. His father was a union man, and his entire extended family enthusiastically supported Roosevelt's New Deal. When he entered the University of Connecticut in 1946 to study economics, nothing in his background or temperament would have led anyone to believe that he would reject the dominant orthodoxy, and to instead embrace the economic views espoused by the out-of-fashion Austrians . . . but he did.

Irwin always had the power of original thinking, which, combined with a rather outsized belief in himself, perhaps led him to sense that the lessons he was learning did not fully mesh with reality. Digging deeper into the full spectrum of economic theory, Irwin came across books by libertarian thinkers like Henry Hazlitt and Henry Grady Weaver. Although his conversion was gradual (taking the full decade of the 1950's to complete), he eventually emerged as a full-blooded believer in sound money, limited government, low taxes, and personal responsibility. By 1964, Irwin enthusiastically supported Barry Goldwater for president.

At the 1944 Bretton Woods Monetary Conference, the United States persuaded the nations of the world to back their currencies with dollars instead of gold. Since the United States pledged to exchange an ounce of gold for every 35 dollars, and it owned 80 percent of the world's gold, the arrangement was widely accepted.

However, 40 years of monetary inflation brought about by Keynesian money managers at the Federal Reserve caused the pegged price of gold to be severely undervalued. This mismatch led to what became known as the "gold drain," a mass run by foreign governments, led by France in 1965, to redeem U.S. Federal Reserve Notes for gold. Given the opportunity to buy gold at the 1932 price, foreign governments were quickly depleting U.S. reserves.

In 1968, President Lyndon Johnson's economic advisors argued that the gold drain resulted not from the attraction of bargain basement prices, but because foreign governments feared that U.S. gold reserves were insufficient to provide backing for domestically held notes *and* foreign notes. To dispel this anxiety, the president's monetary experts advised him to remove the required 25 percent gold backing from domestic dollars so that these reserves would be available for foreign dollar holders. Presumably this added protection would assuage the concerns of foreign governments and would stop the gold hemorrhage. Irwin, then a young business owner in New Haven, Connecticut, thought their reasoning was absurd.

Irwin sent a letter to Texas Senator John Tower, who was then a member of the committee reviewing the gold issue, explaining that the United States faced two choices: force down the general price structure to bring it in line with the 1932 price of gold, or raise gold to bring it in line with 1968 prices. In other words, to adjust for 40 years of Keynesian inflation, America now had to either deflate prices or devalue the dollar.

Although Irwin argued that deflation would be the most responsible course, since it would restore the lost purchasing power of the dollar, he understood that economists erroneously view falling prices as a catastrophe and that governments have a natural preference for inflation (as will be explored in this book). Given these biases, he argued that authorities could at least acknowledge prior debasement and officially devalue the dollar against gold. In such a scenario, he felt that gold would have to be priced at $105 per ounce.

He also feared a much more likely, and dangerous, third option: that the government would do nothing (which was precisely what they chose to do). Then as now, the choice was between facing the music or deferring the problem to future generations. They deferred, and we are the future generation.

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