Is the Market Economy Inherently Unstable, or Is Government the Culprit?

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By Frank Shostak
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Commentary

Following in the footsteps of John Maynard Keynes, most economists hold that one cannot have complete trust in a market economy, which is seen as inherently unstable. If left free, the market economy could lead to self-destruction. Hence, there is the need for the government and central bank to manage the economy. Successful management, in the Keynesian framework, is done by influencing overall spending.

According to this framework, it is spending that generates income. Spending by one individual becomes the income of another individual. Hence, the more that is spent, the greater the overall societal income is going to be. Spending, therefore, drives the economy. If, during a recession, consumers fail to spend enough, then it is the role of the government to step in and boost overall spending in order to grow the economy.

Funding and Economic Growth

What is missing in the Keynesian story is the subject matter of funding. Where does the funding originally come from? For instance, a baker produces ten loaves of bread out of which he consumes two loaves. The saved eight loaves of bread he exchanges for a pair of shoes with a shoemaker. In this case, the baker funds the purchase of shoes by means of the saved eight loaves of bread. The funding of his consumption has to be produced first.

We can infer that what matters for economic growth is not just technology, tools, labor, natural resources, and consumption, but prior production and saving. There must be production before there can be consumption, therefore, consumption itself cannot drive economic growth. Further, capital accumulation that enables more production and consumption requires prior saving. There must be saved goods in the present to sustain people in the process of building up the structure of production.

The introduction of money does not alter the essence of what funding is. Money is just the medium of exchange. It is only employed to facilitate the flow of goods. Money cannot replace the consumer goods since money itself cannot be consumed, but is rather traded for consumer goods. Just spending money—while that does stimulate consumption—does not produce net economic growth.

That said, it is popularly held that the demand for goods is constrained by limits in the money supply. In actuality, the demand for goods is constrained by consumer subjective preferences and the production of goods. The greater the production of goods, the more goods can be demanded. Money—in whatever amounts—cannot have a shortage, since it only facilitates exchanges.

Government Does Not Generate Wealth

The government as such does not produce any real wealth. How then can an increase in government outlays grow the economy? Various individuals who are employed by the government expect compensation for their work. The only way government can pay these individuals is by taxing others who are generating wealth through production and/or exchange. By doing this, the government weakens the wealth-generating process and undermines real economic growth. According to Mises,

"… there is need to emphasize the truism that a government can spend or invest only what it takes away from its citizens and that its additional spending and investment curtails the citizens' spending and investment to the full extent of its quantity."

An important factor that makes fiscal and monetary stimulus appear to "work" is if the amount of private savings are large enough to support (i.e., fund) government-sponsored activities while still permitting an increase in the activities of real wealth-generators. If, however, private saving is insufficient to support both, this will lead to decreased growth. The more the government spends, and the more the central bank inflates, the more will be taken from wealth-generators, thereby undermining prospects for economic growth. As the pace of loose monetary policies intensifies, a situation could emerge whereby production of will actually decline.

Similarly, other wealth-generators—because of the increase in government outlays and monetary inflation—will have less savings at their disposal. This, in turn, will hamper the production of their goods and services and will retard, not promote, overall real economic growth.

Why Economic 'Cleansing' Promotes Economic Growth

Conventional thinking presents economic adjustments—also labeled as "economic recessions" or "depressions"—as something terrible. In fact, economic adjustment is nothing more than when scarce resources are reallocated in accordance with consumers' priorities, and that after a period of distortions brought about by the manipulation of money and credit through inflation. Allowing the market to do the allocation always leads to better results.

Even the founder of the Soviet Union—Vladimir Lenin—understood this when he introduced the market mechanism for a brief period in March 1921 to restore the supply of goods and prevent economic catastrophe. Yet most experts these days cling to the view that the market cannot be trusted in difficult times.

A better way to fix economic problems is to allow entrepreneurs the freedom to allocate resources in accordance with individuals' priorities. In this sense, the best "stimulus plan" is to allow the market mechanism to operate freely. Allowing the market to do the job will result in some activities disappearing altogether while some other activities will be expanded.

Contrary to popular belief, loose fiscal and monetary policies do not rescue the economy, but instead rescue activities that are generating products that are lower-priority for consumers (i.e., consumers are not interested in purchasing those goods at current prices). Loose fiscal and monetary policies sustain waste and promote inefficiency, draining resources from activities that do generate wealth.

Why Doing Nothing Is the Best Policy to Revive the Economy

The decades of reckless monetary and fiscal policies have severely damaged the process of wealth generation and distorted the structure of production. More easy money cannot make the current situation better. On the contrary, such policies only further delay the economic recovery. The best economic policy is for the Fed and the government to do *nothing* as soon as possible. By doing nothing, the Fed and the government will enable true wealth-generators to reorient, save, produce, and exchange. Doing nothing also means that those not generating wealth and/or doing so inefficiently, contrary to the wishes of consumers, will have to scale back, change, or be liquidated. This cleansing process brings the market back into line with reality. So the sooner the Fed and the government remove themselves from the economy, the sooner a genuine economic recovery can emerge.

Conclusion

Contrary to pundits, neither the Fed nor the government's easy money policies can stimulate real growth in the economy through government spending. On the contrary, government spending—facilitated by taxation, debt, and/or inflation—only weakens the process of sustained economic expansion. Were consumption and spending (by individuals or governments) sufficient to cause economic growth, all the poverty in the world would have been eradicated by now. The only reason why these government and central bank policies appeared to "work" in the past is because the source from which governments necessarily take before they can spend—the private economy—had produced and saved enough to temporarily facilitate both real economic growth and increased government spending.

Once the production and savings of the private economy is not enough to support such a system any longer or the distortions to the structure of production become evident, however, the illusion of the effectiveness of these policies is shattered. The more aggressive the fiscal and monetary policies, and the more government spends—which might actually be called *government consumption*—the worse the economic conditions become. There is no need for these Keynesian policies to revive the economy, in fact, they are counterproductive. Counterintuitively, the best policy is for government and the central bank to do *nothing*.

From Mises.org

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Frank Shostak

Author

Frank Shostak, Ph.D., is an associated scholar of the Mises Institute. His consulting firm, Applied Austrian School Economics, provides in-depth assessments and reports of financial markets and global economies. He has taught at the University of Pretoria and the Graduate Business School at Witwatersrand University.

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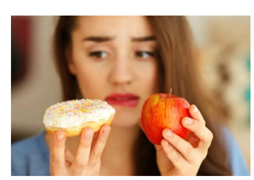

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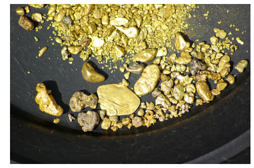

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