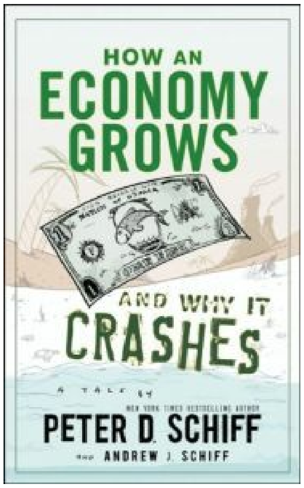

Book How an Economy Grows and Why It Crashes

Peter D. Schiff and Andrew J. Schiff
Wiley, 2010
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Recommendation

Talk about economics for even a few minutes, and watch your listeners' eyes glaze over. But tell them a story that grabs their attention and makes them smile – then you can teach them anything. That's the tactic controversial Libertarian Irwin Schiff used to teach his sons – brokers Peter D. Schiff and Andrew J. Schiff – the basics of economics. The Schiff brothers have cleverly updated their dad's "fish story," first published in 1979, to show how decades of political and economic blunders have led to financial crisis. With cute cartoons and witty, though deliberately imprecise, characterizations, their picture book presents a fable about the ways that politics and human frailty can lead people to violate the rules of supply and demand – thus creating fishy fiscal headaches. Inserted "reality checks" relate the story's ideas to current events to explain the tale's metaphors to readers at all levels of financial sophistication. While some may disagree with the authors' libertarian views, others may recognize underlying realities in their allegory. *BooksInShort* recommends this fine fable to anyone seeking a simple presentation of a complicated subject.

Take-Aways

- Economic truths are the same in powerful nation and on isolated islands.
- This "fish story" is an economic allegory about three islanders, Able, Baker and Charlie.
- To improve his life, Able risks his earnings and effort to catch more fish. Following his lead, Baker and Charlie soon also prosper.
- As the islanders use efficient production to become richer from fishing, and as their savings generate opportunities for others, they learn some real-world fiscal lessons:
- A growing economy boosts spending, but increasing spending doesn't build an economy.
- Governments can thwart the laws of supply and demand for political reasons.
- National banks are able to lower interest rates to encourage borrowing and spending.
- Greater productivity naturally results in deflation, but politicians prefer inflation, which creates the illusion of growth.
- When currency isn't backed by something of value, like gold, policy makers can print money on demand, thus fueling inflation.
- National debts have spiraled; the usual remedies of higher taxes and lower spending may not be politically realistic.

Summary

"The Fish Story"

Economists haven't achieved any feats nearly as monumental as those of scientists in other fields. If aeronautical engineers can send rockets to Saturn, for example, why can't economists predict and prevent financial busts? The "dismal science" gets even gloomier as economists prescribe spending as the solution to current economic woes, piling more debt onto consumers and nations. Who's to blame? Start with John Maynard Keynes, who in the 1920s pushed government spending and regulation as necessary measures to protect jobs. Governments eagerly snapped up the Keynesian worldview, which promised full employment and social benefits without increasing taxes or cutting spending. Banks profited from government programs and incentives to promote borrowing, and universities hired experts versed in Keynesian policies to teach generations of policy makers. The result: Easy access to credit and massive indebtedness – of individuals, businesses and nations – embroiled the world in a mess. Spending on stimulus programs, tax rebates and bailouts isn't going to alleviate this predicament.

> "Throughout history, governments have gotten themselves into trouble by spending more than they have. When the gaps become too big, difficult choices arise."

Libertarian Irwin Schiff had a different answer. Known primarily for his lawsuits and protests against the U.S. income tax (and for acting in opposition to tax regulations, which led to his prison term), Schiff propounded such libertarian ideas as "sound money, limited government, low taxes and personal responsibility." In the late 1960s, he testified before Congress that delinking the dollar from gold would result in "massive inflation and unsustainable government debt." In one of his books, *The Biggest Con: How the Government Is Fleecing You*, he created a parable about three island fishermen to explain basic economics. Schiff originally invented the story to educate and entertain his sons during road trips. Now, they've updated it for modern readers.

"Sharing the Wealth"

Three men live alone on an island with no amenities, no tools and just one food: fish. To survive, Able, Baker and Charlie must catch fish by hand, which is very difficult. They each eat only one fish per day because that's all they can get. "This super simple, sushi-based island society [has] No savings! No credit! No investment!" Yet Able dreams of a better life, so one day he forgoes fishing and eating to invent a gadget that will make catching fish easier. He calls it a "net," and soon he is scooping up two fish a day. By "underconsuming" temporarily and risking his time, he's created capital (his net) and savings (an extra fish). His productivity means that Baker and Charlie can borrow extra fish from him to sustain them while they make nets. They snare more fish and repay Able, so the island economy expands. Supply grows, so demand grows – now the men each eat two fish a day. Most economists believe people will consume more if you give them money. This is a fallacy. Instead, to motivate demand, increase the supply of goods.

> "From gains in productivity all other economic benefits flow."

Island life proceeds swimmingly. Able, Baker and Charlie can now spend less time on subsistence fishing, while storing any excess fish (on this island, fish don't spoil) for a rainy day. Baker soon realizes that a "mega fish catcher" that could trap 20 fish a day would raise their productivity exponentially. The men pool their saved fish to eat while they build their commercial fish trap. Very quickly, they're loaded with fish and each man is free to pursue other interests: Able starts a palm-leaf clothing company, Baker designs canoes and Charlie builds surfboards. Saving for unexpected emergencies, like pesky monsoons, keeps the guys safe from having to start all over again.

"Prosperity Loves Company"

Able created the island's first capital item, his net, and then lent his surplus fish to the others. His sacrifice improves island life for all three men. News of their prosperity soon travels to other islands, whose inhabitants canoe over to share the good life. Now that they are free to take time for play, Able, Baker and Charlie hire these immigrants to cook fish and build huts. This diversification adds a service economy to the island. Bartering soon gives way to an agreed-upon method of exchange: fish. Since everyone knows what one fish is worth, the islanders can use it to price products and services.

> "The simplest definition of 'economics' is the effort to maximize the availability of limited resources (and just about every resource is limited) to meet as many human demands as possible."

Specialization leads some islanders to build canoes. Their improved productivity causes the price of canoes to come down enough so that everybody can afford one. Falling prices give people a good reason to save more fish. Clearly deflation, not inflation, grows economies. But, in general, politicians favor inflation because it creates the illusion that an economy is active and generating opportunity for everyone. The more money in circulation, the more governments can spend on vote-getting public programs.

> "The best thing about private capitalism is that it forces those who may only be motivated by personal gain to raise the living standards of others."

The islanders save so much fish they need a place to keep their catch. Max Goodbank sees an opportunity: If he could both store and lend the fish, making this capital available to others who need it for building huts or canoes, he could profit from the exchange. When his fish storage area is full, Max charges lower interest rates for loans, but when he needs more fish, he raises rates to attract depositors (his "Sea D" rates). A prudent banker, Max won't lend to high-risk ventures, like a slingshot airline company, which unfortunately doesn't get off the ground. That is where Manny Fund comes in: He pays higher rates for fish deposits to finance risky businesses. Between Max and Manny, the island's market for savings and lending sets its own interest rates. In reality, entities like the U.S. Federal Reserve Bank set the rates. The Fed can keep rates low for political or policy reasons, such as keeping the economy artificially pumping along. Low rates lead to more borrowing and less saving. The U.S. has one of the world's lowest savings rates.

> "Policy makers...have made rules that reward spenders and penalize savers."

As the island prospers, Able's, Baker's and Charlie's descendants recognize the need for a central authority that can mediate disputes, protect the citizenry and maintain island infrastructure. So they establish the "Republic of Usonia." Its constitution places all authority in the hands of the people, who elect a dozen senators and one "senator-in-chief." Residents agree to pay for their new government with a fish tax; while they recognize that fish paid in taxes are not available for savings or investment, they are willing to sacrifice for the benefits their government will provide.

The Visible Hand of the Government

Generation after generation prospers. Since the island now needs only a few people to catch fish to feed everyone, Usonians are free to invest and build businesses. Citizens enjoy low taxes and minimal senatorial interference. Then a devastating storm wreaks destruction on the island. Franky Deep, who is running for senator-in-chief against Grouper Cleveland, promises to spend to create jobs to rebuild the island. He issues paper money ("Fish Reserve Notes") backed by fish. But the rebuilding soon costs more fish than the island has saved, so Franky's currency is worth fewer fish. To cover this issue, he creates a "Fishing Department," taking that industry out of private hands. To keep Usonians from panicking and withdrawing their fish deposits, he establishes the "Fish Deposit Insurance Corporation" (FDIC for short) under Ally Greenfin.

> "The longer you eat for free, the harder it is to feed yourself when the free food stops coming."

The government continues to issue paper money. Since it no longer has a profit motive, the Fishing Department becomes lax and inefficient, and the fish it catches get smaller. Now Usonians must eat two fish a day, not just one, to survive. Greenfin explains the inflation of fish prices, or "fishflation," to the public by reasoning that high employment plus a booming economy creates a higher demand for fish, which drives up prices; after all, aren't they all eating twice as many fish as before? As fishflation grows, savings lag and businesses suffer. People lose their jobs. Investors risk their money with Manny Fund to earn more. As the economy worsens, the government sets up price and job controls, but that makes things worse for businesses. Lindy B., running for senator-in-chief against Buddy Goldfish, promises a "Great Society" of "emergency unemployment fish notes to all laid-off workers." Guess who wins that election?

> "Although economists talk like they have seen it all before, the truth is humanity simply has no long-term precedent for universal economic activity based on irredeemable paper money."

Ben Barnacle, the new bank head, advocates spending more Fish Reserve Notes to get people to buy things again. Luckily, a new island called Sinopia wants to buy Usonia's notes with the fish Sinopians catch. This new supply of fish keeps interest rates low and allows Usonians to borrow cheaply and spend more. They outsource more manufacturing to the Sinopians and develop more "service sector" industries. The people of Usonia are becoming consumers rather than producers.

"Closing the Fish Window"

Other islands notice what's going on and begin demanding the fish that back their Fish Reserve Notes. Slippery Dickson, Usonia's new leader, breaks the "fish standard" and the currency's value drops, since it is no longer pegged to the value of fish. But Usonia is so powerful that all the other islands continue to buy and hold Fish Reserve Notes strictly on the basis of Usonia's financial and political clout. Dickson gets caught up in the Watersnake Scandal, which ends his political career. His successor, Roughy Redfish, ushers in a feel-good era of lowered taxes, repealed business regulations and liberalized trade policies, but he continues to spend and spend. Meanwhile, Usonian bankers see a new opportunity to make more money. With the help of two government agencies, Finnie Mae and Fishy Mac, bankers begin lending more freely to buyers of island huts. Soon everyone who wants a hut can afford one. The hut construction, hut sales and hut decor industries soar. The Senate contributes to the boom by making hut loans tax-deductible and by minimally taxing the profits on hut sales. More Sinopian fish pouring into the economy means more available credit and lower interest rates for Usonians.

> "The imposition of a government layer in between savers and borrowers separates the cause and effect of lending, and leads to an inefficient allocation of savings."

Manny Fund's lending lets people refinance their huts and take out the equity that has accumulated due to rising hut prices. "Hut Depot" expands and huts become more lavish. Soon people want more than just one hut, so they buy huts for holidays and for speculation. Prices keep rising, but the politicians and bankers dismiss the possibility of a "hut glut." They want to keep people believing they're wealthy.

> "If consumers are not spending, the best way to spur demand is to allow prices to fall to more affordable levels. Sam Walton made billions with this simple concept."

No one knows when the end will come, but eventually it does. Huts stop selling. Without buyers, prices start to plunge. Hut-related industries begin to fail, and people are laid off. Even businesses that aren't in the hut industry feel the pinch: For example, hut owners had spent their fishing proceeds on bigger wagons that need more donkeys to pull them. Since the donkeys are imported, the "grass guzzler" wagon companies come dangerously close to going out of business. Senator-in-chief George W. Bass listens to his chief fish counter, Hank Plankton, and pumps out more Fish Reserve Notes to get people to spend again and save the economy. But Usonians, spooked by the collapse, hold on to their currency. Soon a new leader, Barry Ocuda, creates tax incentives for hut buyers, begins a program to replace donkeys with more energy-efficient llamas and mandates the "Carp for Carts" program. Increasing the flow of goods thus spurs spending, but as Able, Baker and Charlie first learned, such spending does not expand an economy.

> "Does anybody here remember how to make a net? I think it's time we all went fishing."

Sinopians finally realize that they are buying a currency that is backed only by Usonia's good intentions. They also see that if they divert their fish to their domestic economy, they can build businesses, infrastructures and an economy as vibrant as the one Usonia built. They stop buying Fish Reserve Notes. Usonians soon feel the lack of Sinopian fish, because their money is now worth less. Prices fall freely, resulting in "hyperfishflation." Sinopians smell a bargain (it's not the fish) and start buying all Usonia's assets, physical and financial. Usonians are left with no savings, no infrastructure and no money. "The wealth was simply a mirage."

"The Fish Hit the Fan"

Governments around the world have detached their currencies from their real assets and are printing their way into disaster. Other nations hold more than half of America's debt. Only the reserve currency status of the U.S. dollar has allowed the sale of U.S. Treasury notes to continue unabated, fueling spending and exploding the national debt. With deficits approaching unheard-of numbers, the only options left are to raise taxes, cut spending or default on debt. But tax increases depress productivity and growth, and spending cuts affect the public services that voters want. A default, particularly to foreign creditors, may be the only politically expedient way out. Unbridled spending can lead the U.S. – and other countries – into hyperinflation, which has devastated economies throughout history. Forthright politicians and rational voters must accept hard truths about the future, or soon "we will all be fishing without a net."

About the Authors

Peter D. Schiff is the best-selling author of *Crash Proof 2.0* and *The Little Book of Bull Moves in Bear Markets*. He is president of Euro Pacific Capital, a brokerage firm, where financial media expert **Andrew J. Schiff** is a broker and communications director.