Austrian Monetary Policy Views: A Short Critique

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Austrian business cycle theory is enjoying a comeback because explanations of the recent recession in the U.S. and the current sluggish recovery often have an Austrian flavor (e.g., Laidler 2003; Eichengreen and Mitchener 2003; *Economist* 2002; Oppers 2002). In a nutshell, Austrian business cycle theory postulates that "too low" interest rates induced by monetary policy trigger a credit-financed investment boom—possibly reflected by an asset price bubble[1]—which is unsustainable in the long run so that a subsequent recession not only is unavoidable but necessary to correct imbalances between saving and investment (e.g., Shostak 2002). If the recession is deflationary, there is nothing to worry about due to the stabilizing and welfare-enhancing effects of deflation (e.g., Hülsmann 2003). Policy-wise Austrians recommend the reestablishment of a gold standard to impede monetary policy makers from decreasing short-term interest rates below the natural interest rate which equalizes saving and investment (e.g., Rockwell 2002).

Therefore I want to deal with the following issues from an eclectic, mainstream non-Austrian economics point of view: Should asset price bubbles be pricked by preemptive interest rate hikes? Why should central banks be concerned with deflation? Would a reestablishment of a gold standard be a good thing?

Should Central Banks Prick Asset Price Bubbles?

Yes, I know that Austrians would like to abolish central banks altogether. But we live in the real world and there is a very high probability that central banks will exist in the future. So, should central banks raise interest rates preemptively to prevent the development of an asset price bubble? An Austrian would certainly recommend it (e.g., Sennholz 2002).

During an asset price boom monetary policymakers find themselves in a dilemma (Bordo and Jeanne 2002): If they do not prick the asset price bubble, there is the risk that the boom will be followed by a crash and a credit crunch because decreasing asset prices lead to a decrease in the value of collateral of potential debtors which in turn leads to lower credit lending by banks. In this case a preemptive "strike" in the form of interest-rate hikes would have to be interpreted as an insurance against the risk of a credit crunch. But such an insurance policy against possible future instabilities in the financial sector would imply large costs in terms of ouput losses now. The optimal monetary policy when dealing with asset price developments therefore

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[1] "In principle, a bubble refers to a situation when the price for an asset exceeds its fundamental price by a large margin" (IMF 2003, p. 2 n. 2).

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depends on the relative costs and benefits of this insurance policy. A preemptively tight monetary policy would be optimal if the risk of a crash, including adverse effects on the real side of the economy, is significant and if monetary policy eliminates this risk without large costs. It is a totally different question if and when conditions are given for a preemptive interest-rate hike. In this regard the discussion is not finished yet. Economic literature does not give a definitive answer. Empirical studies are inconclusive (Cecchetti et al. 2000; Goodhart and Hofmann 2002; Bernanke and Gertler 2001; Smith 1999). Right now there is a broad consensus that central banks should not prick asset price bubbles, mainly because bubbles can be detected only *ex post* but not *ex ante* (*Economist* 1999, p. 88).

WHY SHOULD CENTRAL BANKS BE CONCERNED WITH DEFLATION?

Except in the Austrian camp (e.g., Hülsmann 2003), deflation certainly does not have a good reputation. Are decreasing prices not something good, though? Sure, decreasing prices for single goods are welcome but not in the aggregate. First, given contractually fixed nominal wages, decreasing price levels lead to higher real wages and thereby lower demand for labor. Second, given nominal interest rates—especially if the lower zero-boundary is reached (remember Japan!)—deflation leads to higher real interest rates compressing demand for capital goods. Third, given that debt is fixed in nominal terms, deflation leads to increasing real debt of firms and households. This deteriorates the balance sheets of firms leading to deflation-induced bankruptcies. Fourth, deflation gives consumers incentives to delay expenditures to benefit from decreasing prices in the future with the result of decreasing sales of firms. Sure, there are also stabilizing effects of falling price levels as Keynes in chapter 19 of his *General Theory* showed. But the overall effect of decreasing prices is ambiguous (e.g., DeLong and Summers 1986). Due to the possible destabilizing effects of deflation there is a broad consensus that deflation has to be fought by central banks via aggressive and preemptive increases in the money supply or interest rate decreases respectively (e.g., Bernanke 2002).

A REESTABLISHMENT OF A GOLD STANDARD?

It is certainly no exaggeration that Austrians view the introduction of a gold standard as a solution for the boom-and-bust-problem, because credit booms which are held responsible for the boom and the following bust should be less pronounced under this monetary regime (Eichengreen and Mitchener 2003, p. 42). Do the data support this view?[2] The evidence shows that the gold standard before World War I guaranteed no protection against endogenous credit dynamics. Further, there is no firm theoretical basis for the connections between the exchange-rate regime and endogenous credit dynamics. “Our overall conclusion is that the gold standard was neither the cause nor the solution to the credit-boom problem; the effects depended more on how that gold standard was structured and managed” (Eichengreen and Mitchener 2003, p. 47).

Second, there is overwhelming evidence that the Great Depression of the 1930s was initiated by a series of negative aggregate demand shocks (and not malinvestments as Austrians suggest), and that the Great Depression spread worldwide because the gold standard dictated the pursuit of deflationary policies (Eichengreen and Temin 2001; Eichengreen 2002; DeLong 1997). It is for this reason that Eichengreen coined the term “Golden Fetters” for the monetary regime of the gold standard. Vice versa, the road to recovery from the Great Depression was paved by expansionary

[2]“Scepticism about econometric estimates is one thing, and is highly appropriate. But healthy scepticism should not be allowed to devolve into econometric nihilism, which is too often an excuse for wishful thinking and an escape from the discipline of the data” (Blinder 1998, p. 23).

monetary policy after the abandonment of the gold standard (Eichengreen 1999, pp. 2–3). Although there are also voices in the mainstream arguing for the reintroduction of a gold standard (e.g., Mundell 1997), there is a broad consensus that it is better to live without these golden fetters. Why? DeLong (1996) gives a nice survey of the likely adverse effects of a reestablishment of a gold standard: First, governments would lose their ability to tune their economic policies to fit domestic conditions. Second, under a gold standard, the burden of adjustment is always placed on the countries with a "weak currency." Hence higher average unemployment rates are to be expected under a gold standard than under an alternative monetary regime. Third, the average inflation rate would be determined by gold mining. Thus the inflation rate would be determined by political factors that interrupted the pace of gold mining. Be that as it may—one thing is for sure: possibly, no single currency regime is best for all countries and for all times (Bordo 2003, p. 33) as Austrians want us to believe.

Where Does this Leave Us?

In my opinion there is a reason why Austrian monetary policy views are largely not shared by the mainstream. It is not due to a grand conspiracy against Austrian scholars but due to their monocausal,[3] often ideological-driven economic reasoning. In this context I want to follow Laidler (2003, p. 13): "This is not the place to embark on a detailed critique of the Austrian cycle theory. Suffice it to suggest that its exponents took logical possibilities . . . and treated them as logical necessities." It is perhaps worth quoting the retrospective verdict on Austrian theory and its political nihilism by Robbins (1971), himself a long-time Austrian:

> On the assumption that the original diagnosis of excessive financial ease and mistaken real investment was correct—which is certainly not a settled matter—to treat what developed subsequently in the way which I then thought valid was as unsustainable as denying blankets and stimulants to a drunk who has fallen into an icy pond, on the the grounds that his original problem was overheating. I shall always regard this aspect of my dispute with Keynes as the greatest mistake of my professional career. (Laidler 2003, p. 15)

This does not mean that the Austrian monetary theory of the business cycle has to be totally disregarded:

> When all the over-generalizations are stripped away from Austrian theory, there still remains a hard core insight: namely, that discrepancies between the market and natural rates of interest with a capacity for damaging the real economy can arise even in the absence of inflation. This insight seems to be valid far beyond the Austrian theory's own narrow and ideologically drawn boundaries. (Laidler 2003, p. 19)

I have nothing to add.

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[3] Powell (2002): "Only the Austrian theory . . . provides the explanation [for Japan's recession]."

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