Austrian Business Cycle Theories in the Reviews of the Federal Reserve System

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References to the works of economists and economic schools of thought are a relatively recent development in texts of reviews[1] published by Federal Reserve System member banks. Text references in reviews were rare in the central bank's first half-century (1914–1964) of operation. Explicit references to economists and schools of thought began appearing in the late 1950s and early 1960s. The essays in the late 1960s and early 1970s featured references to Keynes and Milton Friedman (Friedman and Schwartz 1963) on the importance of fiscal versus monetary policy. Outstanding examples were in reviews of New York and St. Louis banks.[2]

The Limits of Evolution: Theories of The Business Cycle

The business cycle is a frequently cited topic among references to Austrian economists. There are 11 text references to Austrians in Fed reviews that refer to the business cycle. Austrian business cycle theory (ABCT) identifies the central bank as the cycle's major actor due to its interference with the market and the natural rate of interest. The failure to consider one ABCT variant—the Misesian theory—illustrates the limits of evolution in Fed reviews.

One exception is Formaini (2001, Dallas). The essay does not use the term "malinvestment" but briefly presents a Schumpeterian view of ABCT:

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[1]The 12 Federal Reserve member banks are Atlanta, Boston, Chicago, Cleveland, Dallas, Kansas City, Minneapolis, New York, Philadelphia, Richmond, St. Louis, and San Francisco. For a reference to An Austrian at a Federal Reserve Conference see Paul A. Samuelson, "Summing Up Business Cycles: Opening Address," at Boston Conference Series No. 42: "Beyond Shocks: What Causes Business Cycles?"

[2]For New York see Davis (1968, 1969) and Corrigan (1970). For St. Louis see Brunner (1968), Andersen and Jordan (1968), Fand (1970), and Andersen and Carlson (1970).

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> Schumpeter's entrepreneurs are the causes of business cycles because their actions create dislocations that can come in waves. Cyclic downturns are characterized by what Ludwig von Mises (1881–1973) called a "cluster of errors" as most entrepreneurs suddenly guess wrong. Why? Schumpeter suggests three reasons: (1) innovative ways of applying existing inventions and resources immediately trigger emulation by others; (2) the extra demand that financial backing gives to these undertakings is financed by credit-expanding activities that banks can engage in under a fractional reserve system; (3) the new undertakings generate "spillover effects" and trigger similar dislocations in other industries (Schohl 1999).[3]
>
> Schumpeter emerged from the Austrian tradition, and his business cycle theory as well as his ideas about entrepreneurs were influenced by previous work in that tradition.[4]

The essay notes the key role that fractional-reserve systems—central banks and the *credit structure* (Mises 1912)—play in Austrian theory on economic fluctuations and the business cycle. But elsewhere in Fed reviews ABCT is rarely presented and only within narrow parameters. Hayekian and Misesian cyclical theories are virtually ignored. The most common text citation is to the Austrian Haberler[5] (1937) in Dotsey and King (1988, Richmond); Kydland and Prescott (1990, Minneapolis); Diebold and Rudebusch (2001, San Francisco); and Ludvigson, Steindel and Lettau (2002, New York).

Dotsey and King (1988) cite Haberler as a "classic interwar survey of business cycle theory." They discuss "the role of expectations . . . [which] also constitute an independent source of shocks in "psychological" theories of the business cycle.

Kydland and Prescott (1990) cite Haberler for "an extensive overview" of alternative views of business cycles but also ignore the Austrians. Rather, they present the cycle in light of established neoclassical growth theory. "The study of business cycles," they write, "flourished from the 1920s through the 1940s" but "ceased to be an active area of economic research" in the 1950s and 1960s.

> Now, once again, the study of business cycles, in the form of recurrent fluctuations, is alive. At the leading research centers, economists are again concerned with the question of why, in market economies, aggregate output and employment undergo repeated fluctuations about trend.

[3]Schohl concludes Schumpeter's (1951, p. 155) claim to examine "how firms rise and decline . . . and how this rise and decline affects the aggregates" is still "a neglected issue on the profession's research agenda."

[4]Formaini cites other Austrians on entrepreneurship. These are Carl Menger, Friedrich von Wieser, Friedrich A. von Hayek, Murray N. Rothbard, Ludwig Lachman, and Israel Kirzner.

[5]Craver (1986) and Salerno (1999) identify Haberler with the Austrian school. Haberler studied under Wieser and Mises at the Univ. of Vienna, where he earned doctorates in law and economics. For a review of Haberler (1937) see Ellsworth (1940). Footnote references to Haberler in the era include Cantor and Wenninger (1993, New York), Walsh (1986, Philadelphia); and Kumar and Whitt (1992, Atlanta).

Diebold and Rudebusch (2001) cite Haberler on "maladjustments" in their essay on five unanswered questions about the business cycle:

> The notion of the increasing fragility of an aging expansion had wide currency among business cycle theorists in the prewar era. Gottfried Haberler's [1937] classic synthesis of prewar business cycle theory devotes an entire section to this topic with the title "Why the Economic System Becomes Less and Less Capable of Withstanding Deflationary Shocks After an Expansion Has Progressed Beyond a Certain Point." Additionally, there is a section entitled, "Why the Economic System Becomes More and More Responsive to Expansionary Stimuli After the Contraction Has Progressed Beyond a Certain Point." In both sections, Haberler finds the reasoning, which is based on the inelasticity of the supply of money and of the factors of production, compelling. Indeed, the fact that an economic expansion or contraction gave rise to "maladjustments in the economic system (counterforces) which tend to check and reverse" itself was usually accepted by early writers as "dogma, at least so far as the expansion is concerned."

They conclude:

> As should be evident, although much has been done, many questions about business cycles remain unanswered. For example, a basic question is, What are the causes of business cycles? Can we formulate an explanatory model of economic fluctuations, instead of just a statistical forecasting description of business cycles? In our judgment, there has been very little success in the literature in forging a consensus about the nature of such an explanatory model.

Ludvigson, Steindel, and Lettau (2002) cite Haberler on stabilization in periods of economic fluctuation:

> The wealth channel has deep roots in the literature on monetary policy and economic stabilization, reaching back at least to the earliest literature stimulated by Keynes' *General Theory*. Early on, Gottfried Haberler and A.C. Pigou noted that changes in consumer spending generated by countercyclical changes in the real value of the money stock could help provide an automatic stabilizing force to any economy subject to inflationary and deflationary forces.

The parameters of debate in Fed reviews are broad enough to consider Keynesian, monetarist, psychological, and real growth theories of the business cycle. A criticism is that they are narrowly written in avoiding Hayekian and Misesian theories and any references to malinvestment.

One example is Fuhrer (1994, Boston) who cites the "possibility that output fluctuations affect long-run growth," noting it is "an idea that dates back to Schumpeter (1939)." Contractions might provide opportunities for firms to make structural adjustments that enhance productivity. Yet John Taylor, cited by Fuhrer, finds the "link from fluctuations to growth unpersuasive, since a good deal of restructuring (through 'job destruction') occurs during years when output is at or above potential."

Hayek is termed a "liquidationist," not an Austrian, by Wheelock (1992, St. Louis), in his survey of classical and Keynesian interpretations of the Great Depression. He writes,

> During the Depression, proponents of the liquidationist view argued against increasing the money supply since doing so might reignite speculation without promoting an increase in real output. Indeed, many argued that the Federal Reserve had interfered with recovery and prolonged the Depression by pursuing a policy of monetary ease. Hayek (1932), for example, wrote:
>
> It is a fact that the present crisis is marked by the first attempt on a large scale to revive the economy . . . by a systematic policy of lowering the interest rate accompanied by all other possible measures for preventing the normal process of liquidation, and that as a result the depression had assumed more devastating forms and lasted longer than ever before.[6] (Wheelock 1992, p. 130)

Wheelock observed "the liquidationist theory of the business cycle was commonly believed in the early 1930s," yet "died out quickly with the Keynesian revolution, which dominated macroeconomics for the next 30 years." The Federal Reserve's "failure to respond vigorously to the Great Depression," he concludes, "probably cannot be attributed to a single cause. Each of the explanations discussed in this article clarifies certain points about Fed policy during the Depression."

Exceptions in reviews that cite Austrians are Humphrey (1982 and 1991, Richmond) in which he argues Austrian economists Ludwig von Mises and Friedrich von Hayek relied on "the classical doctrine of forced saving to explain the upswing phase of their monetary overinvestment theory of the cycle." Humphrey avoids the Misesian *malinvestment*, uses the term "overinvestment," and credits Henry Thornton (1982) for introduction of this doctrine, which "refers to the potential rise in the rate of capital accumulation and hence long-term economic growth owing to the inflation-induced redistribution from wages to profit." Thornton, he writes, "anticipated a key feature of those modern neoclassical monetary growth models that treat investment as a function of the monetary growth rate."

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[6]According to Wheelock, "Several key officials shared Hayek's views. For example, the minutes of the June 23, 1930, meeting of the Open Market Committee report the views of George Norris, Governor of the Federal Reserve Bank of Philadelphia:

> He indicated that in his view the current business and price recession was to be ascribed largely to overproduction and excess productive capacity in a number of lines of business rather than to financial causes, and it was his belief that easier money and a better bond markey would not help the situation but on the contrary might lead to further increases in productive capacity and further overproduction.

Another exception is Leeper (1995, Atlanta). Some economists, he writes, believe

> erratic monetary policy plays a substantial role in generating business cycle fluctuations. Among writers before World War II, Irving Fisher (1931), R.G. Hawtrey (1934), Friedrich A. Hayek (1934), Ludwig von Mises ([1934] 1980), and Lionel Robbins (1934) were important contributors to this view.

Leeper observes "monetary policy effects are neither well understood nor easily predicted."

Humphrey (1984, Richmond) rebuts the Austrian School's contention "that monetarists invariably ignore relative price and real output effects in the monetary mechanism." He writes "monetarists, like Austrians," stressed these effects.

> [M]onetarist and Austrian theories of the business cycle share many of the same or similar characteristics. Because of this, the two approaches should be seen as complementary rather than as competing. The similarity between the two views also casts doubt on the notion of a unique Austrian view of the monetary mechanism.[7]

One cannot assume the Fed authors who cite Haberler are familiar with Austrian cyclical theories. Humphrey should be credited for presenting an Austrian view although he rejects it. One is forced to conclude that evolution—and intellectual diversity—still has its limits at the Fed. This becomes more evident when comparing Fed reviews with papers written by economists employed by the Bank for International Settlements and International Monetary Fund that examine Austrian cyclical theories.[8]

Conclusion: The Continuing Evolution of a Human Institution

In 1964, as the Federal Reserve System marked its first half-century, the flagship New York bank's *Monthly Review* published a series of triumphalist essays celebrating a central bank that could do little wrong. One example was the March 1964 essay, "Fiftieth Anniversary of the Federal Reserve System—

[7]For an Austrian reply see Clark and Keeler (1990).

[8]Oppers (2002) cites Mises: "Austrians find the influence of central banks on monetary aggregates potentially troubling. Attempts of the monetary authority to manipulate the interest rate, they argue, will effect the market for loanable funds, inevitably rendering the plans of consumers and entrepreneurs intertemporally inconsistent" (p. 6). Borio and White (2003) describe "a much older tradition in business cycle theory" and observe, "This tradition takes root in work by Pigou (1929), Fischer (1932) and the Austrian tradition (eg., Mises (1912), Hayek (1933) and Schumpeter (1939) among others" (p. 26).

Immediate Origins of the System," which recounts the panics of 1873, 1884, 1893, 1901, 1903, and 1907:

> In the decades prior to the establishment of the Federal Reserve System, it became increasingly apparent that the country's financial system failed to meet fully the needs of a growing economy. These shortcomings were most dramatically revealed in fairly frequent "money panics."

Later that year, ex-New York President Allan Sproul (1941–56), dismissed monetarism in the *Monthly Review* (November 1964). Sproul attacked Friedmanite critics "who would substitute an invariable formula for fallible human judgment or weak human resolve" in monetary policy's conduct:

> I am willing to wait at least until we have more persuasive arguments that a rigid invariable formula can ride through the continuing changes in the economic environment, without the benefit of human judgment and without causing major errors instead of minor ones.

Others were unwilling to wait and by decade's end a debate had broken out in the central bank's reviews around the conduct of monetary policy. *The Federal Reserve Bank of St. Louis Review* advanced a monetarist critique within the central bank in the late 1960s. St. Louis Fed President Darryl R. Francis spoke for many monetarist sympathizers when he told the Arkansas Bankers Association at Hot Springs in May 1969:

> The recent record of national economic stabilization policy has left much to be desired. For almost five years we have had an accelerating inflation which we have not arrested either for lack of will or lack of knowledge as to how to do it. Uncertainty about the role of the Federal budget and about monetary policy has prevailed. Did the inflation come from the Federal spending the budget deficit, monetary expansion or from some combination? Is the cure for the inflation to be found primarily in budget policy or in monetary policy?

To err is human. The monetarist critics were willing to admit the Federal Reserve, a human institution, was capable of error. Defenders of Fed policy such as Sproul acknowledged the Fed was human but drew the wrong conclusion. The Keynesian theory they defended could no longer provide a plausible explanation for events. That theory collapsed in the double-digit inflation and unemployment of the mid-to-late 1970s.

Parameters were widened, debate occurred in Fed reviews, and a new theory emerged. A decade later, another Fed bank president stepped forward to again critique monetary policy. Minneapolis Fed President Mark H. Willes told a meeting in Atlanta, Georgia in December 1979:

> Nobody is very happy with the conduct of monetary policy. The economy has performed badly, particularly in terms of inflation and large costs that go with it. And the near-term outlook for the performance of the economy is grim. Many critics accuse the monetary authorities of failing to deal

> effectively with the problems we have faced, and virtually every policymaker admits that, in hindsight, we have made some mistakes that have added to our economic woes.

President Willes concluded: "Because we know so little, economists and policymakers should be considerably humbler in their policy prescriptions."

The rational expectations critics were willing to admit the Fed, a human institution, was capable of error. The *Federal Reserve Bank of Minneapolis Quarterly Review* championed the rational expectations critique within the central bank in the late 1970s (Lucas and Sargent 1979; Sargent 1980). Parameters widened, debate occurred in Fed reviews, and a new theory emerged. The St. Louis and Minneapolis reviews were unique for promoting new theories (monetarism and rational expectations) termed controversial, even radical by internal critics.

It is possible another humble quest could lead Fed economists to examine ABCT impartially. Fed economists cited Hayek when it was in their self-interest to search for an answer to inflation. It is not in their self-interest to question the *idea* of a central bank. And even if they did it is highly unlikely the Fed would ever embrace ABCT as it did Keynesianism, monetarism, and rational expectations. These schools of thought offered the Fed formulas to promote itself as a stabilizing factor in the economy. ABCT, in contrast, implies that the central bank's very existence is the root cause of the problem of business cycles.

Pride does not lead to humility and a willingness to examine new ideas. Pride leads to triumphalism and sets the stage for human institutions to fail. The idea that Fed monetary policy errors were a contributing factor to the twentieth Century's Great Contraction—the Great Depression (Friedman and Schwartz 1963)—was once widely rejected within the central bank with the rest of Friedmanite economics. It is quaint today to read Davis (1969, New York):

> The view that "only money matters" or, perhaps more accurately, that "mainly money matters" was the province of an obscure sect with headquarters in Chicago. For the most part, economists regarded this group—when they regarded it at all—as a mildly amusing, not quite respectable collection of eccentrics. The number of serious attempts to grapple with the Friedman view on the role of money until recently has been remarkably small.

In this age of Alan Greenspan as Economic Oracle it has been easy for many to forget the Federal Reserve is a human institution capable of error. Throughout their history, Fed reviews have undergone a process of continuing evolution. John Maynard Keynes, Henry George, and Thorstein Veblen were among the scant few economists mentioned in Fed reviews in the central bank's first half-century. In the modern era it is also possible to read about Friedman, Robert E. Lucas, Jr., Thomas J. Sargent *and* Schumpeter, Hayek, Mises and other Austrians. One no longer has to search only footnotes. Ideas are presented in the texts of Fed reviews. The evolutionary process can be seen in the emergence of alternative theories in Fed reviews, including monetarism and rational expectations. Yet despite these developments, the process is stunted and incomplete. Which Fed review is willing to consider nonmainstream theories that question the conduct of monetary policy *today*? Austrian business cycle theory (ABCT) identifies the central bank as the major source of economic fluctuations. To examine ABCT in Fed reviews is to once again acknowledge the central bank is a human institution capable of error. To willfully continue to ignore ABCT is to suggest pride, not humility, reigns.

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