On Economic Crisis, Fiscal Stimulus and Private Money

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Introduction

We are today in the midst of clearly the most severe downturn since the so-called "Great Depression". Interestingly, this economic crisis has also brought to light the fragmentation within the economics profession with regards to macroeconomic phenomena; dare I say that a crisis in economics has come to the surface. There was an almost unsaid agreement within the mainstream economics profession on *Rational Expectations Theory*, a crude version of which says that fiscal and monetary policy become ineffective if expected by rational economic agents. The hypothesis is quite clinically taught in Masters' and PhD programs, and its champions Robert Lucas, Thomas Sargent et al have been for over a few decades the gurus of macroeconomics itself. Then all of a sudden with the financial crisis of 2007 comes back Keynesianism of the oldest and crudest kind, with much support from within the economics profession itself. And really, it took precious little to discard the developments in Rational Expectations theory when it came to dealing with the crisis their assumptions of a perfectly rational individual, perfect information et al had little to do with the real world! So has there really been progress in macroeconomics? If not, why not? And what is the use of complicated mathematical modeling if all of it is merely to be discarded when we face a real world policy question? (A compass is useful because it points to the North Pole, an idea that seems to have eluded many brilliant economists of the recent past!)

Needless to say, students of economics stand to benefit greatly from this crisis within economics, what better time than to study the "production of wealth" in society, than when the battle lines are being redrawn, deadwood cleared, methodology questioned, great champions being brought into disrepute and underdogs having a field day. Unfortunately, the financial sector has been oblivious to these dynamics, or rather potential dynamics. The unanimity in welcoming the "fiscal stimulus" is pervasive enough to make one suspicious! I wish to congratulate students, teachers and other individuals involved in bringing out this first issue of the CESP Journal at such an opportune time, and for the Socratian spirit of inviting a varied range of views.

Technical Explanations versus Economic Explanations

Typical explanations of the present financial crisis begin from the housing bubble burst, which caused bank asset values to plummet, holders of credit default swaps (CDOs) then got hit and short term money markets dried up. Investment banks owed people money, but couldn't borrow from short-term money markets because banks didn't trust each other anymore. For a very short period after the collapse of Lehman Brothers, AAA lenders

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refused to grant loans to AAA borrowers!

From a technical point of view such an explanation is perfectly correct; from an economic point of view it is almost perfectly useless. Business cycles are more than a century old, and some of the downturns have been more severe than others. Our primary challenge as economists is to position and explain the present financial crisis within a broad business cycle theory. This is not to deny that the present circumstances will have peculiarities of their own, but to merely state these peculiar events in their temporal order is not an economic explanation.

I shall in this essay paint an elementary sketch of the current economic turmoil from the perspective of Austrian Business Cycle Theory (ABCT). The name of course comes from the fact that scholars like Ludwig von Mises and F.A. Hayek spent the pre WW-2 years in the University of Vienna.

Austrian Business Cycle Theory

ABCT is founded on the idea that there is something called the 'natural rate of interest', or better still 'natural rate of *interests*'. Individual economic agents have a time-preference, just like they have a preference for goods over bads. I prefer to have a glass of wine this evening rather than a year from now. I prefer to have a Mercedes S class today, rather than 10 years from now. Naturally then, if you are to convince me to forgo consumption today, in other words if you are to convince me to save, I will ask for a profit. So two glasses of wine six months from now in return for forgoing one glass tonight, for instance. The ratio between the quantities of good in time period 1 to quantity of good in time period 2 may be called the natural rate of time preference, the numerical correspondent of which is the natural rate of interest.

In modern national economies, the price of capital i.e. interest, is not discovered by the market, but centrally planned by the concerned national bank. The Reserve Bank of India determines the price at which it will lend to retail banks, which in turn influences the price at which retail banks lend to entrepreneurs. Herein lies the seed of cycles of booms and busts.

Soon after the dotcom bust, the Federal Reserve officially adopted a low interest rate regime. The Fed rates were below the natural rate of interest, encouraging entrepreneurs to invest in projects which were not feasible. The idea of infeasibility is key. When individuals voluntarily lend to each other at natural rates of interest, economy-wide real savings are employed for economy-wide real investments. With lower than natural rates of interest, investments are not backed by sufficient real savings. On the contrary, lower interest rates discourage savings and encourage investments, a rather absurd phenomenon in itself!

Consumers continue to demand goods and services for present consumption as before, and entrepreneurs demand goods and services for investments at an increased rate. The economy itself is pulled in two opposing directions, and imbalances are rampant. Monetary demand begins to fuel inflation, the Central Bankers panic, raising interest rates. Many of the investment projects which were profitable under the earlier lower rate of interest now become unprofitable, and must be abandoned. In other words, factories were being built which shall begin production ten years hence, but consumer time-preference demanded goods four years hence. These production plans must be torn down; inflation does cease but enter a phase of recession.

Also, within ABCT, 'capital' is not a homogenous commodity. The very first of Hayek's 'Pure Theory of Capital' is committed to explaining the heterogeneity of capital itself. This is important because the misallocation of resources due to centrally determined rates of interest is not only a misallocation in terms of the time-structure of production, but can take the form of misallocation across different goods. A lower than natural rate of interest not only encourages entrepreneurs to build longer gestation period production facilities, but can make profitable the production of some goods which would have been wholly uneconomical otherwise. A low interest rate does little but lower an element of cost (interest) of production while leaving the price of goods unchanged in the short run. This short run modification in relative prices can lead investments in production of goods which are out of line with the preferences of budget constrained consumers under natural rate of interest.

When we speak of aggregate investment, and other aggregate macroeconomic figures, the very economic problem of misallocation of resource both with regards time-structure and nature of production is lost. Say the diverse economy wide capital employment can be captured by a co-ordinate on a n-dimensional space by (x, y …q). the fundamental problem with the Keynesian methodology of aggregation is that when they speak of "aggregate investment" by transforming such an n-dimensional vector into a point on the real number line, they delete the very essence of our economic problem, i.e allocation of resources.

The Austrian approach on the other hand is concerned with individual preferences and allocation; it is in essence methodologically individualistic.

As for the current crisis, the post-dotcom bust low interest rate regime combined by fiscal measures enacted through government controlled Fannie Mae and Freddie Mac meant that much of the *bad credit* drowned the housing sector in particular. The rest, of course, is a mere technicality.

Fiscal Stimulus a bad idea

Keynesianism in the old form has returned, at least in the policy circles. And

Governments world wide have announced so-called fiscal stimulus packages. The idea behind fiscal stimulus is to boost what Keynesians call “aggregate demand” which is the sum of (1) consumption (2) investment (3) net exports and (4) government expenditure. When private consumption or investment declines, the Keynesians like to boost exports and government expenditure to keep up the aggregate demand. But this kind of thinking is flawed at many levels.

First, the word “aggregate” empties the words “demand” and “supply” of any useful meaning. A tea-vendor supplies tea and demands sugar, tea leaves, cooking gas etc. a smelting factory supplies iron and demands iron-ore, coal etc. now imagine adding up each individual producer's supplies and demand; what sense does that make?

Second, an economy is a *complex system* the essence of which cannot be captured in arithmetic. There are plenty of technical mathematical definitions of what constitutes “complexity”. The most fitting for economics, I think, is the following: an economy is a system of interactions between heterogeneous agents the outcome of which is inherently indeterminate with respect to *specificities*. *Heterogeneous agents* refer to the fact that individuals are different; one is an entrepreneurial cook, another a cricket star, yet another a wine loving economist. And the outcome of interactions between these individuals is inherently unpredictable with respect to specificities. Think of a football match for instance. Eleven players on each side, simple rules, yet would you be able to predict and draw all the paths a football would traverse in the course of a match? Last year I was at a conference on modeling interaction between heterogeneous software agents in Trento a gorgeous little city in the bosom of the Italian Alps. A Swedish economist there said that “government intervention in a complex system is not like throwing a stone, but like throwing a bird.” A great analogy, I think. To this, another economist said, “Hush, if the government gets to know, they'll kill the bird before throwing it.” Jokes apart, government 'management' of an economy is really out of the question. Since our very problem is of misallocation of resources, government intervention at the aggregate level is targeting the wrong animal; discretionary fiscal expenditures will only further misallocate resources.

Third, government expenditure will only further misallocate resources since the planner has no way of aggregating ever changing preferences of millions of individuals (Mises-Hayek thesis of the impossibility of rational planning in a socialist economy). The Planning Commission of India just doesn't know whether people want guns or butter, how much of each, what quality. Moreover, the fiscal spending will fall to political favouritism. This is why you hear complaints from some quarters; someone's got to lose out in lobbying.

Fourth, Keynesians think that government expenditure expands aggregate demand by a multiplier effect, i.e when the government builds a factory, the workers get paid Rs 100, they spend Rs 60 on food, and the farmer in turn spends Rs 40 on shoes and so on. So the

total boost is not Rs 100, but Rs 200 (100+60+40). But the same is true when an individual spends, and therefore when the government taxes the factory worker Rs 100, the effective economic burden is Rs 200 (she cannot buy food for the amount, the farmer in turn receives nothing to buy shoes). The so-called "fiscal policy multiplier" is not some sort of a magic wand exclusively in government hands. On the contrary, it follows from the very principle of exchange (Say's Law itself).

Of course Keynesians may say "but workers reduce consumption during recession"; yes they do, and that is because savings are necessary to rebuild capital lost by misallocation. This is yet another insight form ABCT; because so much capital has been destroyed by a lower than natural rate of interest lending, now we need more saving to replenish economy wide production. Factories designed to build luxury cars will have to be redesigned to build cheaper wheels; economy wide churning means much destruction of machinery and investments in human resources. The redesigning of factories and production processes needs savings, and therefore increased savings is perfectly consistent with an economic recovery.

The way ahead…

In short, private money. Money itself was not invented by the government; it was discovered and evolved through repeated use of certain long lasting, light-weight precious commodities. Carl Menger in his *Principles of Economics* explains the spontaneous emergence of money, like language, through spontaneous market processes. In fact, as early as 1860 there were hundreds of different currencies floating in the US, and the economy was certainly producing much wealth.

Note that private enterprise in money will yield lending and borrowing at natural rates of interest, in the same way that the market clearing price for other commodities are reached by the process of competition and bargaining. Also, within the Austrian paradigm one does not assume perfect competition or perfect knowledge; these neo-classical notions are completely discarded. A legitimate query at this stage is what if the private producer of money prints notes which are not backed by real deposits; no one is checking the vaults really. While governments may inflate currency and get away with it mostly, private players cannot afford to do so. The currency of a bank which prints more money than its deposits will depreciate with respect to competing currencies, encouraging individuals to switch to holding their wealth in other currencies. Moreover, without a lender of last resort, banks that experience a bank run due to imprudent banking may well see their management behind bars for breaking contract law, very different of course from the present system where the culprits themselves are formally invited to the Treasury to discuss a bailout plan!

But what if the private money issuers form a cartel, and print more money in co-operation with each other? Certainly the consumers would get impoverished, and one will see no

movement in their relative prices. We will, however, observe a change in the value of gold in terms of these inflation currencies. Consumers, realizing that they would lose value holding these currencies will demand a unit of exchange which is linked to gold or silver. This gives rise to an entrepreneurial opportunity to provide money backed by gold; enter a new competitor, and the cartel breaks as consumers shift en masse. Knowing this line of reasoning, it makes no sense to form a cartel in the first place.

A system of private enterprise in money will prove to be a boon particularly for the poor. The richer sections of society hardly ever lose out to inflation; they hold their wealth either in real estate, gold or other investments hedged to inflation. But the poorer individuals hold part of their wealth in cash holdings, and even their bank savings are not perfectly hedged to inflation. This system of regressive inflation tax would come to an end with competition in money.

Conclusion

ABCT does a pretty good job at explaining the present economic crisis, and makes it clear that a fiscal stimulus hardly addresses our fundamental problem of economy wide misallocation. Neither is a more prudent monetary policy, either targeting money supply or inflation or other macroeconomic variable likely to help; the central banker has no way of aggregating the time preference of millions of individuals. It is time we economists pay more attention to the possibilities that a system of private money may have to offer.

References:

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