Utah FOUNDATION RESEARCH BRIEF

Thoughts on the Current Recession: Austrian Economics

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This brief is part of a series of research briefs Utah Foundation is publishing on the economy. The series examines the current economic recession from a variety of schools of economic thought. These schools of thought represent different approaches to understanding how the economy works and what actions to take when the economy falters. We began the series with a discussion of Keynesian economics, and are now examining the Austrian school. Other briefs will outline the theories and observations of the Post-Keynesian and Chicago schools of thought. Understanding these different schools of thought will help readers further understand the roots of the economic crisis and potential solutions.

Austrian Thoughts on the Current Recession

Unlike most mainstream schools of economic thought, the goal of Austrian economics is not to obtain market equilibrium, but rather to understand the process by which knowledge is generated, transferred, and used within the economy.[1] The emphasis on economic process, rather than end states, stems from the notion that behavior and actions take place through time, not within a static model. Austrian economists believe that an individual can decide on a goal and act to attain this goal, but because the individual is faced with conditions of uncertainty there is no guarantee the individual will achieve the goal. The end state therefore changes based on the interactions and new knowledge obtained by the individual.

Because Austrians view end states as variable, they define economic efficiency as the process and fulfillment of the purpose deemed most important to the individual at any particular time.[2] This is opposed to mainstream economics, which typically defines economic efficiency as market equilibrium, or the point where the production of goods and services is maximized.[3] Austrians reject the notion of maximization and believe efficiency can only exist within the individual.[4]

As a result, Austrians focus on the institutions that emerge as people operate within uncertain economic conditions. Money is an example of such an institution; it was developed as a medium of exchange to decrease the amount of uncertainty traders were faced with when bartering over goods and services. Because money is accepted by all parties, producers do not have to worry about obtaining all the goods they need and can specialize in one area. By understanding how and why such institutions emerge, Austrian economists seek to determine which institutions or regulations enable individuals to reach their goals and which do not. Their policy recommendations center on changes and improvements that need to be made to the institutional framework in order to reduce uncertainty and allow individuals to freely achieve their goals.

While Austrian economists acknowledge some institutions are helpful to the individual economic process, they tend to view most institutions and regulations as inhibiting individuals from reaching their goals. Therefore, they tend to support a free market and laissez-faire governance. They believe government intervention hinders the process and decision making of market participants, resulting in suboptimal economic conditions.

For example, Austrian economists believe the business cycle of booms and recessions is the result of systematic intervention in the market process by the government.[5] Specifically, they argue that business cycles are the inevitable consequence of ineffective central bank policies, which cause interest rates to remain too low for too long.[6] Low interest rates stimulate borrowing from the banking system. The resulting expansion of credit leads to an expansion of money supply and an unsustainable boom, prompting investors to seek out risky investment opportunities promising high rates of return.

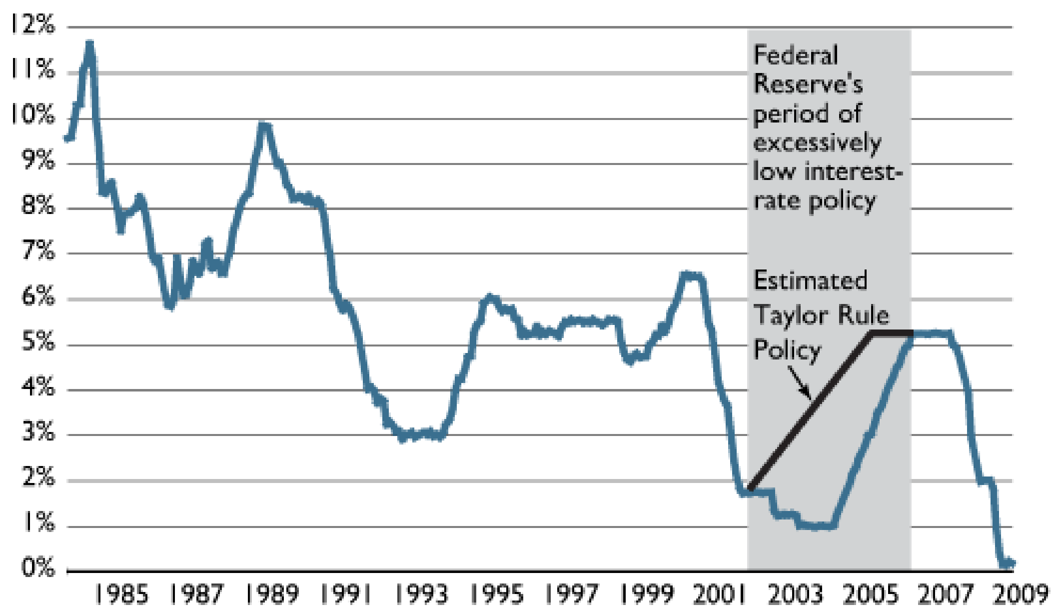
During this period, capital resources are misallocated into inefficient and risky areas that would not attract investment if the money supply had remained stable. The boom period ends when credit creation can no longer be sustained and the money supply contracts. Eventually markets clear as resources are reallocated toward more efficient uses. In this context, recessions are viewed as positive forces that act as the market's natural mechanism of undoing the misallocation of resources. However, Austrian economists argue it is government actions that cause money supply expansions and inflation in the first place, which results in the subsequent depression-adjustment period when the inflationary period is no longer sustainable.[7]

Causes of the Current Recession

Like many Austrian economists, Mario J. Rizzo, a professor of economics at New York University, believes the current recession was caused by the Federal Reserve's low interest-rate policy that lasted from about mid 2002 through the third quarter of 2006.[8] Figure 1 uses economist John Taylor's "Taylor Rule" to illustrate this low interest-rate policy. The blue line shows the actual interest-rate decisions of the Federal Reserve from 1984 to 2009. The estimated Taylor Rule line shows what the interest rate would have been had the Federal Reserve continued the same monetary policy in 2002 that it had used during the previous twenty years of good economic performance. As shown, the actual interest-rate decisions were well below what the Taylor Rule would have estimated—suggesting monetary policy was "too easy during this period."[9] While John Taylor is not considered an Austrian economist, the Taylor Rule is useful in illustrating the Federal Reserve's low interest-rate policy.

While effects of the Federal Reserve's policy were compounded by additional problems in the financial sector, Austrians argue the low interest-rate policy was the direct cause of the economic boom and subsequent bust. This is because it led to the unsustainable misdirection of capital to the housing market, which became overinflated. Low interest rates tend to encourage purchases of consumer durable goods and the development of capital projects because the present value of such goods and projects is increased relative to what it would be at higher interest rates. When interest rates rose, however, resources moved away from these industries and many projects and homeowners, who borrowed on the assumption of continuing low rates, found they could not pay off or refinance their loans. Banks and homeowners lost capital, meaning those who purchased securities based on these loans lost capital as well.

Figure 1: Federal Funds Rate, January 1984 - March 2009



The Taylor Rule line is an estimate what the interest rate would have been if the Fed had continued the same monetary policy it had used during the previous twenty years (it is a smoothed version of John Taylor's 1992 proposed policy rule).

Source: Federal Reserve Bank of St. Louis (FRED), The Economist (18 October 2007).

Rizzo also argues the magnitude of the current recession is due to the fact that interest rates were intentionally held so low for so long. This allowed resources to be allocated into various sectors in a way that was not sustainable, but the resulting impact was undetectable because of the low interest rates.[10] For instance, the American automobile industry has been unable to compete with foreign manufacturers for several years, but the industry's problems were masked by rising demand between 2002 and 2006. However, this demand was artificially stimulated by increased household borrowing based on low interest rates and the inflation of real household assets such as stocks and home values.

Austrian Solutions to Recessions

Because Austrians believe recessions are caused by government interference, they believe the best way to end a recession is to cease all intervention in the market. Austrians argue the longer the government keeps interfering in the market, the longer it will take the market to readjust. Because this readjustment period is viewed as natural and necessary, Austrian economists also argue that the government must never try to prop up unsound business situations as this will only delay the inevitable correction.[11] The government should also do nothing to encourage consumption or increase its own spending; rather, it should encourage savings in order to counter some of the excessive investments of the inflationary period. The less the government does the more rapidly the market can adjust and the economy can recover.

Austrian Solutions to the Current Recession

> Based their theory of the business cycle, many Austrian economists believe the solution to the current recession is for the government to do nothing; there should be no stimulus packages, no government bailouts, no changes in the interest rate—no fiscal or monetary policy responses of any kind.

Austrian economists believe the solution is simply time. It will take time for the market to wipe out all of the bad investments created by the credit boom. It will take time for risky projects that were undertaken to go bankrupt, for extra employees who were hired to be laid off, and for the wage level to shift downward.[12] Once the economy has been cleansed from these bad investments and decisions, it can begin to recover. Austrian economists argue the only way the government can speed up the recovery process is by cutting taxes, which puts more wealth into private hands, and weakening or eliminating regulations that inhibit private sector growth.[13]

Like many Austrian economists, Peter Schiff, President of Euro Pacific Capital, believes the solution to restoring economic vitality in the United States is to allow the recession to run its course. He argues that letting the free market operate without inefficient and ineffective government involvement allows the market to correct itself by eliminating the distortions and imbalances that caused the recession. Letting the market correct itself will also result in a quicker and more meaningful recovery. In terms of the government's role, Schiff argues lawmakers should vote no on all bailouts and begin eradicating budget deficits by eliminating profligate spending. The government should also move to more of a laissez-faire approach by cutting corporate and personal income taxes and minimizing corporate regulation. This in turn would increase savings, job growth, and real industrial production, as well as let the market—not the government— determine which institutions prevail and which ones fail.[14] Schiff also argues the Federal Reserve should be restricted from setting interest rates and printing excess money as a way to increase the money supply.

Mark Thornton, a senior resident fellow at the Ludwig von Mises Institute, argued in September 2008 that in absence of all the actions the government has taken to prevent the recession, the corrective phase of the business cycle would have already occurred. While he recognizes the housing market would have remained in a slump for several months, he believes restorative market forces could have already created new companies and jobs if not for the actions of the Federal Reserve and Treasury Department.[15] Given the extraordinary nature and precedent of government intervention in this recession, Thornton believes the government is setting up the U.S. economy for the next great depression because of the length of time of the boom period and the amount of money taxpayers will have to pay to cover the deficit. Like other Austrians, Thornton argues that in order to avoid the next great depression all government intervention should cease immediately. Instead the government should focus on balancing the budget and cutting taxes and regulations.

Historical Notes on Austrian Thought

The Austrian school dates back to Carl Menger's 1871 publication of the Principles of Economics.[16] However, it is most closely associated with the 1920-1940s works of Ludwig von Mises and Friedrich A. Hayek, which focused on the causes of business cycles, monetary theory, and economic polices related to unrestricted free markets and private property rights.[17] While the Austrian school gained popularity during the 1920s, its theories were not accepted by most economists after World War II, largely because of Mises' rejection of traditional economic mathematical and statistical methods.[18] However, the school regained some popularity in late 1970s and early 1980s after Friedrich A. Hayek was awarded the 1974 Nobel Memorial Prize in Economic Sciences. While Austrian economics remains popular among libertarian groups and provides useful insights on credit bubbles and business cycles, it is still not widely accepted among most mainstream economic circles.

Endnotes

[1] Deborah Walker, "Austrian Economics," in *The Concise Encyclopedia of Economics*, 2nd ed., ed. David Henderson (Indianapolis: Liberty Fund Inc., 2007), http://www.econlib.org/library/Enc1/AustrianEconomics.html (accessed 5 March 2009).

[2] Walker.

[3] Joseph Schumpeter, "Methodological Individualism," from *The Nature and Essence of Theoretical Economics (1908), trans. F.A. Hayek, Institutum Europaeum, 1980, available from http://mises.org/books/schumpeter_individualism.pdf (accessed 17 March 2009).*

[4] Walker.

[5] Murray Rothbard, "Economic Depressions: Their Cause and Cure," *Ludwig von Mises Institute Daily Archive*, 2 October 2008, http://mises.org/story/3127 (accessed 10 March 2009).

[6] Thorsten Polleit, "Manipulating the Interest Rate: a Recipe for Disaster," *Ludwig von Mises Institute Daily Archive*, 13 December 2007, http://mises.org/story/2810 (accessed 12 March 2009).

[7] Rothbard.

[8] Mario Rizzo, "The Misdirection of Capital and the Current Recession," *Ludwig von Mises Institute Daily Archive*, 19 February 2008, http://mises.org/story/3348 (accessed 5 March 2009).

[9] John Taylor, *Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis* (Palo Alto: Hoover Institution Press, 2009), 2.

[10] Rizzo.

[11] Rothbard.

[12] Rockwell Llewellyn, Jr., "Why Austrian Economics Matters," *The Heritage Foundation,* Lecture #368, 12 March 1992, http://www.heritage.org/Research/Economy/HL368.cfm (accessed 16 March 2009).

[13] Llewellyn.

[14] Peter Schiff for U.S. Senate, "Peter's Solutions," 28 January 2009, http://www.schiff2010.com/peters-solutions (accessed 13 March 2009).

[15] Mark Thornton, "How to Avoid Another Depression," *Ludwig von Mises Institute Daily Archive*, 10 September 2008, http://mises.org/story/3103 (accessed 16 March 2009).

[16] Walker.

[17] Murray Rothbard, "Ludwig von Mises (1881-1973)," *Ludwig von Mises Institute*, http://mises.org/about/3248 (accessed 30 April 2009).

[18] Roger Backhouse, "Austrian Economics and the Mainstream: View From the Boundary," *The Quarterly Journal of Austrian Economics* 3, no. 2 (2000): 31-43.

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