Austrian Interest Concepts and the Great Recession

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"Perhaps more fallacies have been committed in discussions concerning the interest rate than in the treatment of any other aspect of economics."

--Murray Rothbard

A. Some Basics: Interest Rates

Interest rate theory provides a frame through which to view an economy in action. Close analysis reveals why the underlying interest rates visible in markets are low in some years (such as the near-zero short-term rates from 2010 to 2015) and high in others (such as the nearly 20% rates in 1980).

We will outline a generally agreed-upon description of interest rates and the forces that influence their changes.

Controversy stems from misunderstandings regarding the ultimate forces that affect interest rates and about how other economic measures can be said to interact with interest rates, such as the desire to invest, spend, or hold onto money balances.

Financial professionals, as well as lenders and borrowers of money, strive to remain aware of the current influences on interest rates.

Technically astute observers acknowledge the Fed's power to disturb the trends in rates, especially short-term rates, but know that, broadly speaking, except during periods of financial stress, Federal Reserve Policy only appears to independently set absolute rates for the economy rather than merely influence them.

We will see that rates, adjusted for price inflation, as seen in loan markets, ultimately reflect underlying economy-wide production and asset price differentials dispersed over time,

What is interest? Popular usage portrays interest as the price of money, determined by the supply and demand for money.

This is inaccurate. Trained economists state this more precisely: They define the interest rate as the premium or cost of borrowing, or the time price of money.

Clearly, the price of money is its purchasing power, the conceptual inverse of the weighted prices of goods and services, not interest rates. The price of a building may be a result of its stream of discounted future rental incomes; its price is not its yearly rental income. The price of money cannot equal its yearly rental value, which is the rate of interest. The desire for money balances can be neutral or non-neutral with respect to interest changes, and similarly for prices, because the use of money is ultimately governed by its exchange for goods and services.

Interest and demand for money

Standard economic models employ various interactive variables that determine the interest rate. It is specified as a function of the supply and demand for money balances, with interest, in turn, affecting the motives to hold money balances.

By contrast, we highlight the classical view among Austrian writers that the supply and demand for money, rather than primarily determining the interest rate, largely determines the price level (loosely defined) under various credit conditions.

DSGE (dynamic stochastic general equilibrium) models utilize the interest rate agnostically as a mutual variable in equations throughout the model without addressing its underlying formative properties.

Principles courses properly designate the *supply of money* as money balances outstanding, with the *demand for money* being the propensity to hold these balances.

However, as we will see later, the demand for money is predominantly described incorrectly as the obverse of the *velocity* or turnover of money.

Rather than the rate of turnover, the degree of subjective preference for money versus goods matters for prices. Velocity is an inappropriate term for this phenomenon.

Interest, prices, and time preference

Money prices reflect more than timeless or present (marginal) utility considerations, they relate the disposition of goods in terms of present value to future returns reduced by temporal discounting (time preference). For example, volume discounts can include a price discount today for goods to be used later.

Goods are also subject to a *time value* specific to each good. This is in addition to *time preference*. Ice in summer has a different *time value* than ice in winter. For a specific good, time value may dominate time preference.

Money is different. Money lacks time value changes, allowing it to reflect social time preference.[1]

The interest rate relates present money to future money, and so, when devoid of premiums for risk or price inflation, it reflects social time preference.

Ratios of present versus future prices underlie the *Pure Time Preference Theory of Interest* (PTPT) employed by key Austrian economists. However, to isolate the time preference element, the comparison is between the universal bartering good — the money unit — in its present use versus its future use.

We will see that it has been argued that the rate of price inflation can be appended as a premium to augment the basic rate of interest, but it is this basic rate absent this premium that interest rate theory must explain.

The prevailing theory employs investment prospects, specifically the productivity of capital or the marginal efficiency of capital, to help explain credit demand.

Key Austrians challenge this productivity explanation for determining the basic interest rate. They point out that the rates of return for investments cannot be used to determine the interest rate when the values of investments have already been discounted according to that same rate. Mises, in particular, rejected the neoclassical formulation of the investment demand function. Such a view is unique to Austrian economists.

[1] Herbener (2011) attributes this understanding to Frank Fetter.

The marginal productivity of capital is a return per annum. It is problematic when depicted as an investment demand curve in the interest rate markets. An individual can act both as a supplier and a demander of present goods. For example, one can run a balance on a credit card (a form of borrowing) and simultaneously own shares in a bond fund. In our analysis, these don't cancel but enter into both the market demand and supply schedules. An employee, a demander of present goods (income), can be, and often is, at the same time, a capitalist supplying savings to the market, a present good. Rothbard states,

"The same person can be at once a laborer, a landowner, and a capitalist in the same period of time."[2]

Time market vs. loan market

The general, yet mistaken, attachment of importance to the entrepreneur as the relevant agent behind loanable funds demand should come as no surprise. Certainly, the importance of the entrepreneur as an efficient allocator of productive activity has been too long underplayed.

Yet, the entrepreneur is not at the center of interest rate determination. Speculation, when contributing to the coordination of the economy by speeding adjustment to change, constitutes part of the entrepreneur's indispensable role in taking on the risk and reward of profit and loss.

For this very reason, Austrian theorists such as Mises and Rothbard, who stress the intermediary but not the primary role of entrepreneurs as players in the time market, have not been widely heard on this point. For these key writers, the time market, not the loan market, governs interest rates.

Most observers of financial markets naturally view interest as emerging from the interaction of supply and demand in loanable funds. As a habit of thought, for those who think about the financial markets, supply and demand curves for loanable funds seem to interact so that a rate of interest is hammered out. Most view the time market as being subsumed within the loan market. However, we will see how our key Austrians distinguish between the time market and the loan market.

When it comes to decisions that holders of productive assets (capital goods) exert on markets and the economy, a sound grasp of the differences between the loan market and the time market matters, especially when it comes to defending either Austrian or neoclassical Keynesian capital theory, as will be illustrated later in this discussion. Terminology can be blamed for some lack of clarity on this point. [3]

B. Interest and Inflation[4]

We note how abstract reasoning facilitates analysis and that models of the economy necessarily ignore complexities by employing assumptions.

We have noted that models may abstract too much; they can overlook stages in the chain of business activity, such as those extending from resource extraction to manufacturing and processing, and from processing to wholesaling and retailing. Such amalgamation into a single process obscures details crucial to the Austrian dynamic analysis.

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[2] Rothbard (1962) p355.

[3] Garrison (2001) used what is largely the *time market* as a key element in his model but denoted it as the *loan market*.

[4] Mises preferred to use the term *inflation* to indicate increases in money or credit not counteracted by increased demand for money balances. Inflation connotes *expansion more so than mere rising,* and so Mises' view is well taken. We must, however, acknowledge the conventional use of the word to mean rising prices. For clarity, we will sometimes speak of price inflation and of money inflation.

As a result, it is easy to overlook the importance of maintaining the great structure of production through the ongoing process of reinvesting and saving. Mental constructs easily overlook the importance of not consuming and the need for savings to channel funds into business activities that are the precursors to consumer goods.

Models may employ assumptions that obscure the impacts of changes in money and credit flows and interest rates. They may overlook the distorting effects of credit expansion on the profile of the structural edifice in the economy, an edifice comprising, in part, multi-enterprise, vertically un-integrated, sequential stages of production.

Austrian writers emphasize these temporal and spatial structural elements. The Austrian Business Cycle Theory (ABCT) highlights the inadvertent, asymmetric, yet systemic economic distortions that result from the impacts of monetary policy.[5]

Standard Neoclassical treatment of interest rates employs averages, such as the average *price* inflation rate premium, in the loan market rate of interest. F.A. Hayek cautioned that the use of macroeconomic aggregates and averages was at the root of the failure of monetary policy to progress. Essential understanding can begin with such concepts, but average prices provide no insight into the most important aspect of monetary theory: the changes in microeconomic elements relative to one another among sectors and subcategories of the economy.

The dissimilar effects that changes in the money supply exert throughout the production sectors of the economy are closely tied to the business cycle. Unfortunately, monetary theory, except from the Austrian perspective, lacks this emphasis. Monetary influences go undetected when theorizing relies on average price levels, aggregate spending, or aggregate capital formation. Hence, monetary distortions can occur under price stabilization policies with as much consequence as during periods of (price) inflation or deflation.

Purchasing power premium

In this section, we see how interest rates can be altered by inflationary expectations. We then extend the discussion to a conventional view of influences from the demand for money and to Austrian business cycle analysis. The use of averages and aggregates is only preparatory to the necessary employment of disaggregates for this analysis.

Economists use price indexes, such as the CPI or GDP deflator, to adjust market rates to real rates. Although the analysis has conceptual significance, in practice, such indices can never be formulated adequately for consistent policy reliability. From a scientific standpoint, prices of heterogeneous goods cannot be unambiguously added together, much less averaged.

Austrians are aware that expectations can never be quantified by probability analysis, that they are sometimes ephemeral, sometimes interactive or self-adaptive, sometimes anticipated, but never definitive.

Setting aside these severe limitations, we can gain insight into how economists evaluate interest rates by abstracting from the spectrum of rates across various loan time horizons. When economists refer to the

[5] Rothbard (1972) conveyed the essence of the Austrian view on the business cycle with a succinct critique of standard Keynesianism. F. A. Hayek wrote extensively on this subject but without explicit endorsement of the time preference theory of interest, maintaining that central bank lowering of the current rate of interest below the equilibrium market rate during monetary expansion operates to produce the business cycle, irrespective of the ultimate determinants of the interest rate (Hayek 2012: 126).

interest rate, they are typically speaking of the most visible interest rate, the money or nominal rate observed in the bond and loan markets.

The real rate is a calculated rate deflated or inflated by the rate of price inflation or deflation.

The *ex-ante* real rate is the market rate adjusted for expected price inflation. Retrospectively determined, the *ex-post* real rate is the recorded rate adjusted for the period in question by the rate of (price) inflation or deflation that transpired in that period.

Looking back (*ex-post*), it might mean that unanticipated price inflation, for instance, reduced the interest payments in real terms to below what had been intended; the real rate was lower than expected.

For example, if last year the observed (nominal) rate was 2% and we discovered that price inflation last year was also 2%, then the (hidden) real rate would have been zero, not, say, 1%, had we prematurely thought inflation would be only 1% last year. [6]

The standard theory posits that if inflation (or deflation) of prices is anticipated or expected for some time, then nominal rates become higher (lower) to compensate lenders for the expected loss (gain) in purchasing power of money over time, as the (hidden) real rate is adjusted to what was intended. In this case, the difference observed between the money (or nominal) rate and the (hidden) real rate has been termed the *price expectations effect,* or *Fisher effect,* after economist Irving Fisher.

During a period of price inflation, the Fisher effect refers to the observed price inflation premium reflected in the market (nominal or money) interest rate. For example, if the prospective nominal rate for this coming year is 3% and the expected inflation rate is 2%, then the expected (hidden) real rate is 1%, and the Fisher effect would be 2%.[7]

For some economists, a near-zero (nominal) rate targeted by the Fed for the Federal Funds (inter-bank loans), such as in 2009, was seen as containing a price deflationary decrement or negative price premium, leaving the estimated real rate positive. Market adjustments for downward price changes may result in a real rate as described above (the Fisher effect), producing a higher real rate alongside a depressed nominal rate.

Conventional economics thus adds a premium to the interest rate that appears appropriate. However, as we will see, this adjustment requires amendment when taken at face value, exclusive of considerations arising from an understanding of the origins of the market interest rate, i.e., if taken by simply examining the loan market without considering the time market.

Other rates observed on the market reflect various positive premiums for risk separate from the Fisher effect. Thus, 10-year junk bonds may be at 8%, with safer 10-year Treasury bonds at 4%.

Limitations to the use of these calculations arise because no single objective rate of inflation can be established out of the incomparable price data on the totality of goods and services.

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[6] The real rate is not to be confused with the *pure rate*, which is the real rate free of any risk premium as would be expected under equilibrium states with uncertainty absent. Rothbard noted that the pure rate may be thought of as the basic rate. Also there are often differences between short term and long-term rates. Economists refer to a term structure of interest rates depending on the length or term of the loan or the maturity of a bond. This structure (represented by a yield curve) is normally positive with short rates lower than long, but can be inverted with long rates lower than short (usually occurring at the on-set of a recession).

[7] A popular measure of short-term inflationary expectations results from taking the difference or spread between the 2-year TIPS (Treasury Inflation Protected Securities) and the 2-year Treasury note that, for instance, in early 2010 indicated about 1.5% inflation.

For instance, during periods of economic boom, some asset prices, such as real estate or equities, may be underrepresented or ignored in price indices, as was the case in the 1920s, or even in the 1990s or early 2000s. Moreover, the currently used indices understate housing costs, omit fuel and food costs, and employ dubious hedonic adjustments that compromise and degrade their usefulness.

Monetary policy thus labors under this information handicap.

Dynamic effects possible

What is more, market participants adjust price changes more directly than through a price premium on interest rates. The Fisher effect is not the only mechanism available to the market to compensate for inflationary expectations; present prices might be adjusted instead, thereby pre-empting projected price increases such that expected future price increases would be lowered (a rational-expectations effect).

Again, Austrians especially decry any mechanical application of the Fisher effect, even when price indices can be reasonably established.

Why observed rates may stay low even with inflation

Regardless of the ultimate causality behind dislocations that may explain interest rate behavior in the economy, the difficulties in understanding alone would caution against any confidence that monetary policy might be stabilizing. Standard approaches see profit rates enhanced by lower borrowing costs when interest rates are low. However, it is seldom recognized that higher profit rates may have something to do with what raises rates. Additionally, when observing Treasury securities, a lower rate may indicate a 'flight to safety,' whereby lending or investing is shifted away from private market securities and into Treasuries, and vice versa.

When considering market forces that interact to determine the interest rate, conceiving the loan market as only dealing with financial transactions overlooks the trading actions that have the most significant impact on interest rates. The time transactions between input providers and productive firms and agents, as well as between the pricing of goods and assets or capital that provide for future returns, contribute to the aggregate social time agio or premium. We see the outcome of all time markets in the loan market interest rate.

An implication of the rational expectations effect is that nominal interest rates over a period of anticipated price inflation may never attain a fully compensating inflation premium. Rates may remain modest during a recovery.

It is possible that the stubbornly low to zero interest rates in 2015, for instance, were not simply a result of ZIRP (Zero Interest Rate Policy) but resulted in part from entrepreneurs anticipating that profit rates would likely rise as the recovery progressed. Experience in periods of inflation bears out that profit rates rise. Hence, prices of inputs may rise immediately in anticipation. So even though inflationary expectations for this group need not be a direct cause of a higher price premium in the loan market (absent loan market participants with high inflationary expectations), the increase in inflationary expectations outside of the loan market in the production market would operate not to raise nominal interest rates but to reduce them as prices of inputs remain higher thereby inhibiting a price-spread widening. Because price spreads are the underlying basis of rates, rates would also not have risen.

Hence, during a recovery, expected higher returns may result in prospective investment commitments that increase the demand for future (input) goods, and so keep input prices up, depressing interest rates. This would act as an infusion of spending into the production structure, lowering rates (price spreads) in

the same direction as increased quantitative easing, due to reduced demand for more liquid asset holdings. In other words, commitments encouraged by the knowledge of a pattern of higher-than-normal profit rates during expansions may thus shift the supply of investible funds curve outward. This effect causes lower rates. This differs from low-profit expectations in that it reduces rates just as when the demand curve shifts down (explained further below).

Rates may remain subpar for various reasons. As a result, if authorities do not see a significant inflation premium, they may become less cautious about inflation and may overprescribe easing.

Conversely, perhaps later in the recovery, an inflation premium may be real. Authorities could overreact to high rates due to an unnoticed inflation premium. After a long period of easing to reduce rates towards a target rate set too low, a monetary authority might then become too expansive in order to combat high interest rates.

We note that, as an example of the difficulties with the Fisher effect as a mechanism compensating for inflation, a rational expectations effect (Rothbard, 1962) incidentally becomes the dominant one under hyperinflation.

Accordingly, when markets are moved even further away from their tenuous internal course towards coordination by mostly monetary bank-credit-related impacts, readjustment processes may be overwhelmingly complicated. In short, interest rate targeting is plagued by too many unknowns, as well as a misapprehension of the impact of open market operations, which overrates the effects on the interest rate through the dependent loan market rather than the time market.

Austrian credit expansion effect

Interest rate analysis faces further problems where prevalent explanations may be inadequate–there might be yet another reason that the real rate is low, thereby resulting in skewed investment commitments. This conforms to the ABCT. This artificial lowering of the interest rate was earlier known to be a Wicksell effect (after economist Knut Wicksell)[8] operating as a side effect of money supply injection.

Rates may be held too low with monetary easing because analysis using price indices fails to account for productivity increases, where normality might be gradual price deflation (termed *growth deflation*). Given that dollar GDP cannot grow without monetary accommodation, analysts are misled. GDP numbers can fail to measure advances in economic activity unless accompanied by monetary growth.

In other words, regardless of the interest rate, price deflation may cause authorities, by calculating GDP measures that falsely indicate economic recession, to ease monetary policy and lower rates below what would balance the markets. The near-zero short-term interbank rate may have been artificially pushed lower than the natural rate, as it now appears was the case in the early 2000s and 1990s.

As widely explained by Austrian economists, during periods such as in the 1920s, actual significant effects of quantitative easing were unrecognized by economists due to the lack of general price inflation. The 1920s began with an overhang of war bank credit expansion that was never purged and, moreover, was continued through the period.[9]

[8]Murray Rothbard referred to Wicksell as the "Swedish 'Austrian'." (1993 396) and Professor Mason Gaffney referred to Wicksell as "arguably the smartest economist of all times." (2012: 2)

[9]See Rothbard's investigation into the 1920's (1963, 153-164) Wicksell, unlike the Austrians, saw these effects principally when accompanied with price-inflation.

It has been thought (as we will note below, most notably by Keynes himself) that if the end of a period of lowered interest rates caused the apparent cessation of expansion and boom, then logic would argue in favor of reinstituting easing to correct the recession. However, the reason that a low interest rate cannot return us to the boom of the expansion is that the expansion was a period of ongoing ever-worsening alignment of complementary productive processes. Even elevated measures of employment and higher measured GDP during that misalignment would not be sustainable.

So, Austrians see beneath the cover of total measured economic activity. Their more sophisticated model comports with common sense. We can consume capital on the one hand and invest in the wrong capital projects on the other. Each supports measured GDP, but each of these subtracts from the ability to deliver supplies of usable goods and services in the future.

The correction not only must revalue these misappropriations, but it must also liquidate some of them at a loss and terminate whole enterprises that are the most out of line with balanced production. Some of the workforce must be relocated and retrained.

A community could initiate a project to construct a tunnel, thereby avoiding a challenging journey over a mountain. It could employ engineers, train workers in demolition and excavation, and invest in heavy equipment. However, if halfway through the mountain, the community runs out of the means to support its workers, then when they return to their original activities, the community will have nothing to show for its work, being worse off due to having depleted funds and resources. Yet, while engaged in the project, it was experiencing a boom in employment and economic activity. Its economists maintained they were on the right track because they enjoyed a high level of aggregate demand; however, they were misled about their current resources. Their recession is clearly not from a lack of effective demand.[10] It was from the misdirection of resources. Similarly, recessions, in general, should not be automatically attributed to inadequate demand.

Some of the disruptive effects of a boom occur because of a bubble in land prices. Hence, the advantage of building vertically is that it utilizes a smaller footprint of land (i.e., an increase in the marginal rate of substitution of capital for land). In consideration of this effect, which conforms to the general ABCT, high-rise buildings can be overbuilt after commitments were made in the boom. In fact, a boom in high-rise construction has been used as an indicator in forecasting recessions. The Empire State Building's construction began just as the Great Depression developed in 1929.

Growth deflation

Austrians view periods of gradual price reductions due to productivity increases, such as those that occurred in much of the 19th Century, as healthy and normal, especially under a market-regulated monetary system, which, being free from political manipulation, more easily avoids the excesses endemic to fiat monetary regimes.

Targets, and investor caution

Target rates are not the only indicator of Fed policy efforts. Even when the Fed is unable to reduce interest rate targets because they are already near zero, the Fed can undertake quantitative easing by increasing the money supply.

[10] If "effective demand" were defined in accordance with Say's Law then we would not be justified in using the term synonymously with spending that merely or only temporarily raises the GDP.

Mises, Keynes, and liquidity

Perhaps the most celebrated landmark in economics after Adam Smith was the publication of John Maynard Keynes' The General Theory of Employment, Interest, *and Money* (1936).

Foundational to Austrian economics, Carl Menger's subjective marginal analysis revolutionized classical economics, where prices were henceforth seen as determined on the margin, not by classes of importance, costs of production, or labor content. Building on that tradition were Ludwig von Mises' *The Theory of Money and Credit* (1912) and *Human Action* (1949).

Austrians emphasized a demand-based process of valuations underlying the constellation of prices. Both supply and demand are demand-oriented. Producers ultimately base decisions on consumer preferences. Distinct from this is the concept of a demand-driven economy, which attributes a healthy economy to a high ratio of consumption to saving. For Austrians, values are determined by consumers. Demand is imputed to factor inputs. Austrians reject the idea that spending on current consumption as opposed to saving is the driving force of the economy.

Taking a wider view, all economic activity, including saving, ultimately aims for consumption, whether present or future. However, consumptionists wrongly attribute investment demand to present consumption demand, rather than prospective demand.

The conventional understanding is that demand for final products, including immediately consumable or disposable goods, determines economic performance. In contrast, the production of future utility should be seen as dependent on factor inputs and capital goods.

The demand for money, or liquidity, has long been a focus of monetary theory, particularly among quantity theorists. During the 1930s, unlike the recent experience, rates were elevated. Keynes saw the flight to liquidity in a credit contraction as contributing to higher interest rates, as savings withheld were not being offered on the market as investible funds. [11]

Rates in 2008

The full explanation for the observed rates may depend in part on whether, in such a downturn and financial contraction as that beginning in 2007, there is increased demand for more liquid short-term instruments (but not necessarily an increase in demand for money itself), thereby lowering short-term interest rates. Does this work in the direction of depressing short-term rates as funds flow out of financial investment instruments into, for instance, treasury bills? As we will see, determining this is no simple, predictable matter and constitutes another source of frustration for monetary authorities in reading the economy. During a correction, it would be natural to expect a steepening of the yield curve due to a risk premium in longer commitments. The 2008 spike in the saving rate was a defensive action to hold more liquid financial assets.

In the eyes of the financial and economic community, the 2008 financial contraction produced a shock to markets that effectively dried up demand for credit, except for Federal deficit borrowing.

One might conjecture that market interest rates were suppressed partly due to reduced borrowing resulting from falling profit expectations, as well as suppressed by quantitative easing efforts by the Fed.

[11] Revealingly, Fritz Machlup noted in Laurence S. Moss (1976, 9-12) that Keynes had given a cursory and critical review of Mises' 1912 untranslated German edition of *The Theory of Money and Credit*, but only years later did he (Keynes) reveal that he was an unaccomplished reader of German.

We have discussed other influences on short rates, but most analysis mistakenly assumes that policy alone is dominant.

A conjecture of increased risk assessments would produce a market interest rate-suppressing effect from the shift in asset preferences away from equities to more risk-averse, short-term, government-insured deposits and government securities. It would also lead to a general retrenchment towards increased savings and liquidity from current income. We know that by 2010, the (income) saving rate had moved back up from its low of around 2% earlier that decade to better than 3%, while funds had yet to shift back into equities in a substantial way, savers still preferring short-term deposits and government securities until later years.

Keynes confined his analysis to the tradeoff between bonds and money balances. Hence, if we had an increase in demand for money balances to meet the desire for liquidity, Keynes's relation would indicate some short-term upward pressure on interest rates. Increased demand for money resulted in less spending on bonds, which raises interest rates.

Importantly, Austrian theory allows for rates to change based on saving-consumption ratios independent of concurrent changes in money demand.

The determinants of the saving rate as a percentage of income differ from those governing accumulated savings. During the recession that began in 2007, there was a shift away from tangible assets, such as titles and real estate, to liquid assets or cash, resulting in a decrease in the perceived value of capital and savings.

Over-optimism led some asset values to become too high during the boom. In reaction, those values can be pushed too low, but the market tends to readjust best when not burdened by policy uncertainty.

In consideration of the low interest rates and rescue policies for large hedge and pension funds, there may be a parallel between the mistaken inverse relationship between inflation and unemployment, and what could be called a 'liquidity curve.' Here, instead of a supposed trade-off between inflation and unemployment (the Phillips curve), it may be that there is an overly simplified idea of a trade-off between general widespread price inflation and monetary easing. Indeed, recent booms generated price bubbles, not general price inflation.

Inflation and Booms

Thus, contrary to the prevailing economic thinking, we did not have excessive savings leading up to a crisis. Credit expansion constitutes false savings. When prices catch up, there is no net gain in savings. We are reminded by Mises of the distortion in asset prices during the boom. Asset (and producer input) prices were inflated and needed to be de-inflated to allow markets to clear (Mises, 1966, chap. XX).

For Austrians, even a sharp downturn in valuations is an attempt by markets to return to normal after the boom. The actual "shock" to the market emanates from credit expansion and its ramifications. It has become increasingly evident from the magnitude of the 2007-2008 credit contraction that this correction followed decades of excessive debt accumulation, credit leveraging, and declining saving rates as a percentage of GDP.

Boom conditions resulted from the appreciation of asset valuations as markets gradually reflected increased confidence in the extension of credit spurred by accommodative easing and by a climate of over-optimism in business due to an extended period of price increases.

We are reminded that no economy-wide upward movement of prices can occur without either an increase in the money supply, an increase in credit leverage, or a sustained lessening of liquidity

preferences (i.e., a reduced desire to hold money balances). Such occurrences have historically been under conditions of outside money or credit inflation (French, 2009), usually exacerbated by a wealth effect resulting from the artificial stimulus of stock prices, financial instruments, or real estate.

During the post-war period, monetary authorities maintained a low target rate of price inflation, ranging from 2 to 3%. Cumulatively, such rates are not inconsequential, even at 3%, prices double every 23 years. Asset bubbles emerge when prices have risen to the point that speculators enter the market, even if they are aware that fundamentals may not support ongoing price appreciation. Administered rates of inflation (even if seemingly low), when prices would naturally be gradually falling, provide the 'leavening' for the production of asset bubbles.

The 2007 crisis was the culmination of a unique combination of financial and credit distortions, as well as endemic moral hazard. Just as important as monetary policy interference was an unprecedented neutralizing of normal market caution. The result was risk and debt overextension, as well as the unrestrained use of real estate as a collateral base for lending by the banking system, primarily instigated in Washington, exemplified by Freddie Mac and Fannie Mae.

Lack of information for managing the Economy

However, the authorities were unaware of the developing imbalances until the advent of the financial crisis in 2007. Aside from the aforementioned limitations in the measurement of price inflation, no definable grounds existed for appraising the extent of the Fisher effect. Inflation indices were unreliable in attempts to obtain a clear understanding of the economy; the inexact measurements of current price inflation rates only become available after the data is evaluated. Steady price inflation in one year does not extrapolate to future years. Price inflation is a dynamic and unstable phenomenon characterized by disequilibrium.

George Reisman, with a Ricardian slant to his Austrian analysis, finds no place for the Fisher effect because interest rates reflect profit rates; the profit rates would already include expectations of price level changes. The Austrian insight was made explicit by Rothbard — that interest rates in the loan market must reflect rates of return in the economy, especially given the enormous size of the quantities supplied and demanded on the time market. If, in time, prices come to reflect inflationary expectations, the interest rate would be devoid of a Fisher effect, and this would control the loan market rate with no extra premium tacked on.

The task of managing the economy was underestimated. Calculating interest rates, as we have seen, is a complex and challenging task. Retrospective calculation of real rates is more straightforward; however, current price changes in some sectors may be unmatched in other sectors due to complex transmission mechanisms.

Once the recession is underway, unlike mechanisms during inflation, corrective price deflation in consumer goods that reduces profit rates might be expected to elicit only a lagged fall in producer input prices, keeping in mind that, as Reisman emphasized, product pricing is usually a mark-up due to the cost of production. The result may be a delayed lowering of relative prices for inputs of original factors and capital goods due to greater price rigidity at this stage than at the final retail interface. Such lag would result in price spreads narrowing and loan market rates falling or failing to increase accordingly. However, it would not prevent reduced factor quantity demanded and a decline in employment, as prices may be slow to adjust downward to a new equilibrium.

In fact, this kind of adjustment discontinuity may be expected to first work against any rise in interest rates for some time by keeping price spreads relatively narrow. “Historically, it has often been the case that product prices rise more rapidly and fall more rapidly than prices of original factors.” (Rothbard 1962: 698), so final goods prices may fall before factor input prices.[12]

ADDENDUM

11/22/2024

On Interest Rates:

- Effects from money supply changes
- Effects from credit conditions
- Effects of price inflation
- Effects from profit rates
- How price spreads affect profit rates
- Do inflationary expectations only affect short-term rates because current price changes can wash out future inflation?
- Fed policy. Taylor Rule. Duel mandate.
- Fed has little effect on rates and so is always catching up; policy lags 3month Treasuries.
- The problem with the Fed is enabling Treasury borrowing by Fed purchasing debt.
- Because of productivity deflation, the market inflation rate should be even lower than the target inflation rate of 2%.
- Austrian time market rules interest rate, not loan market.

Business Cycle concerns:

- GDP a poor measure
- Unemployment Rate better
- Capacity Utilization also better
- Ricardo Effect: boom in fixed capital industries reverses due to increased profit rate. Fixed capital is stimulated due to reduced real wages when CPI rises.

[12] Note that this is not the same as saying that capital goods prices fluctuate in amplitude less than final goods over the business cycle, which given time is not the case.

- Increased profit rates steer business investment to enterprises with the most rapidly circulating capital and away from capital-intensive enterprises.
- This is a change in capital intensity or capital valence.

Volker Fed policy

- High interest rates occurred in the late 70's early 80's because of Fisher effect inflationary expectations that were unanticipated in commodity markets.
- Mises was right that unexpected inflation (increased consumer goods prices) distorts (raises) perceived profit rates.
- This underlies the rise in interest rates produced by profit rates generally, while also not generally experiencing a fisher effect in the loan market.

Fed policy

- Fed open market operations only affect interest rate movements in the very short run due to market expectations that it has a governing effect. In actuality it has little effect because of the much larger time market determined by price spreads throughout world markets that rule the level of interest rates.
- This is why data reveals that Fed policy is reactive to interest rate changes overall, a lagging, not leading, series. It explains recent movements in interest rates, which have returned to levels below what most analysts expected due to the so-called expansive policy.
- Since profit spreads govern interest rates, moderately high interest rates indicate a healthier economy, while low interest rates indicate a depressed economy.
- The common view is that inflation spurs interest rates, but published inflation rates are predominantly lower than actual due to government data manipulation.
- The current high interest rate in Russia (16%) should not be seen as a reaction to high inflation (although the published inflation rate is at 8%, it is likely higher).
- This high interest rate indicates both a risk premium due to its geopolitical problems with the Ukrainian conflict as well as high investment opportunities bringing up the demand for loanable funds.
- This means that over the last few decades, low interest rates in the West could be attributed to depressed economies where profit spreads were compromised by various barriers to progress.
- Share prices may outrun the actual profitability of the economy in a country due to speculation or currency depreciation (inflation).
- Hence, the fear that an increasing deficit will drive up interest rates unsustainably is unfounded. In fact, even a $ 2 trillion deficit is a small piece of the overall time-market volume of transactions when considering that more than just the GDP must be counted, because of all intermediate transactions in the structure of production. Other measures of economic activity include gross output (GO) and gross domestic transactions (GDT).
- Of course, along with a comment that Rothbard once wrote to the effect that the problem with fiat money is not that it must lead to imminent economic collapse, but that it can sustain the dysfunctionality of the system undeterred for too long, the problem with deficits is that they can do their dirty work for far too long.

- And by dirty work, we must take issue with the Modern Monetary Theorists (sic) who opine that since savings must be absorbed by instruments somewhere, government debt is just a convenient way for the public to hold its savings.
- In fact, the government has three ways to use the funds.
- Firstly, is spending on reasonably efficient expenditures such as infrastructure, transfer payments back to taxpayers, legitimate welfare, etc.
- Secondly, ridiculously wasteful programs and agencies that we all know account for much of the budget.
- Thirdly, destructive expenditures include not only interventions that destroy foreign nations and wealth but also subsidize inefficient enterprises and fund the administrative state that, in effect, legislates regulations and promulgates harm to productive sectors and liberties.
- It is usually accompanied by infusions of funding to the corporate industrial complexes.
- Besides the burden on future taxpayers, the borrowed funds represent a drain on loanable funds availability for the non-government sector (crowding–out).
- This brings us to the motivation for surreptitious engineering of international military conflict or other emergency treasury expenditures.
- It stems from gains to be made from the extension of credit to finance expenditures.
- During war emergencies or other fabricated emergencies, such as a global pandemic, central banks facilitate treasury debt, which generates a stream of interest income for the banking sector.
- Hence, another reason for eliminating central banks such as the Fed.