

2/7/13 Why holding down interest rates doesn't help.

It has been thought that if the end of a period of low interest rates caused a recession, then logic would argue for reinstating the policy of lowering rates to end a recession. However, the reason 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, elevated employment, and GDP notwithstanding.

Austrians have emphasized the folly of thinking of the economy as either enjoying more or less economic activity. Their more sophisticated model is common sense. We can consume capital on the one hand and invest in the wrong capital projects on the other. Each of these contributes to GDP. But each of these subtracts from the ability to deliver supplies of usable goods and services in the future.

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

A community could begin a project to build a tunnel to access what requires a difficult journey over a mountain. It could employ plenty of engineers, train workers in demolition and excavation, and invest in heavy equipment. But if, halfway through the mountain, the community runs out of the means to support its workers, then when they return to their original activities, they have nothing to show for their work and are worse off for having depleted their resources.

Yet, while engaged in the project, they were experiencing a boom in employment and economic activity. Their economists said they were on the right track because they enjoyed a high level of aggregate demand, but they were misled about their provisions, as the authorities distributed them at a rate that would deplete stores faster than they could be replenished.

Artificial credit stimulation can have similar results.