Mainstream Macro in an Austrian Nutshell

BY ROGER W. GARRISON

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Of all the losses suffered during the current recession, one of the most notable (and well deserved) is the loss in reputation suffered by today's macroeconomics textbooks. J. Bradford DeLong admits as much—even of his own textbook—in a recent lecture on our current financial crisis. While the events that have unfolded over the past year have required some outside-the-box theorizing by mainstream macroeconomists, the economists of the Austrian school can offer a straightforward, fill-in-the-blanks explanation by drawing on the theory first articulated by Ludwig von Mises and then developed by Friedrich A. Hayek. DeLong blithely rejects the Austrian account. In his lecture delivered January 5, 2009 in Singapore, "The Financial Crisis of 2008-2009: Understanding the Causes, Consequences—and Possible Cures," he fabricates a "Marx-Hoover-Hayek axis" (complete with adjoined photos of this unlikely trio) and then offers a brief and ill-informed critique under the heading "The 'Austrian' Story in a Nutshell." (His lecture is available at http://www.tinyurl.con/c8van.)

A true-to-Hayek nutshell version of the Austrian theory is not difficult to produce: The central bank is central to our understanding of the current crisis. The Federal Reserve under the leadership of Alan Greenspan kept interest rates too low during 2003 and 2004 and then ratcheted the rates steeply upward. Time-consuming investments that were initiated while cheap credit made them artificially attractive were then made prohibitively costly to carry through. Macroeconomically, that sequence translates into an Austrian-style boom and bust. The background against which the story unfolded was a long-running, politically motivated sequence of housing policies whose dubious goal was to

increase home ownership beyond what mortgage markets themselves would allow. The actual effect of the various policies was to desensitize both lenders and borrowers to the risk of default, causing mortgage markets and hence housing markets to play leading roles in this particular boom-bust episode.

The Austrian theory couldn't be more tailor-made for understanding our current situation. Dealing with the unfortunate consequences of artificially cheap credit, a memorable passage in Mises's *Human Action* (3rd ed., 1966, p. 560) alludes to an overbuilt housing market:

> The whole entrepreneurial class is, as it were, in the position of a master-builder whose task it is to erect a building out of a limited supply of building materials. If this man overestimates the quantity of the available supply, he drafts a plan ...[that cannot be fully executed because] the means at his disposal are not sufficient. He oversizes the groundwork and the foundation and only discovers later in the progress of the construction that he lacks the material needed for the completion of the structure.

The foiled plans in Mises's parable represent the upper turning point of the business cycle. The subsequent compounding of the downturn in the form of a downward spiral into deep recession should not distract attention from the underlying problem of the credit-induced misallocation of resources. The solution must entail, in the first instance, a reallocation of those misallocated resources.

If credit creation by the central bank was the cause of the problem, it is doubtful that still more credit creation is the solution. Similarly, if investment activity was overstimulated by cheap credit, it is doubtful that a stimulus package will hasten recovery. Why, then, isn't there a general recognition of the implausibility of these textbook solutions? And why don't mainstream macroeconomists see the direct applicability of the Austrian theory and the appropriateness of a market solution to the crisis?

For the economist-turned policymaker, the answer is simple. Policies based on mainstream thinking—cheap credit and stimulus packages—are politically attractive, a circumstance that makes any theory, particularly as it might apply to the long run, wholly irrelevant. Attempts to rekindle the boom also satisfy the "don't-just-stand-there criteria" for political viability. *In the long run, a boom will get you a bust; but in the short run, a boom will get you votes.* No doubt, many elected officials are oblivious to the first part of this long-run/short-run distinction. And virtually all those not so oblivious see the second part as trumps.

For academic macroeconomists, especially for those trained and employed by top-tier universities, we need a two-part answer to our question. For Part I we must recognize that economists who were trained at Harvard or MIT and hold a faculty position at Berkeley or Princeton have trouble grasping the Austrian theory. They learned their (short-run) macroeconomics and their (long-run) growth theory in two different sets of courses. The capital theory that unites these two subject areas in the Austrian literature was effectively out of play in both sets. In mainstream macro, where business cycles were discussed, capital is assumed to be fixed. In mainstream growth theory, where cyclical movements are assumed away, capital is allowed to grow or to shrink, but it enters the theory as a holistically conceived capital stock.

By contrast, the inherent time dimension in the economy's capital structure makes capital theory a natural common denominator for Austrian macroeconomics and Austrian growth theory. Capital is a sequence of stages of production; its temporal structure is a key macroeconomic variable. Interest rates that reflect people's preferred tradeoff between consuming now and consuming later guide capital creation and allow for sustainable growth. Almost as a corollary, interest rates that are distorted by central-bank policy *mis*guide capital creation and give rise to *un*sustainable growth. The inevitable bust (in the recent and earlier episodes) is a dramatic manifestation of the growth rate's unsustainability.

To mainstream macroeconomists, the mix of cycles, growth, and the temporal allocation of resources makes Austrian theory appear as a disorienting mish-mash. The mainstreamers are not won over; they are simply flummoxed. At best, they will try to fit piecemeal the various propositions put forth by the Austrians into an otherwise mainstream theoretical framework. Distortions of the capital structure get translated into unwarranted changes in the size of the capital stock; the plausibility of entrepreneurs being misled by cheap credit gets judged in the light of presumed "rational expectations." The unemployment of labor during the period of capital restructuring gets questioned on the basis of the efficient-market hypothesis. Individually, the pieces don't fit, and so collectively the Austrian propositions are rejected wholesale. (Notice that the Austrian theory is better received by Wall Street analysts trained in finance and attuned to the real economy than by academic macroeconomists.)

Part II of the answer to "Why don't the mainstreamers see the Austrian theory's relevance?" actually deals with a follow-on question. "Why don't they at least make the effort to learn what the Austrian theory is?" After all, economists who study and teach at top-tier universities are intelligent people who *could* learn the Austrian theory. A little reflection suggests that while they surely have the ability, they lack the motivation. For a seasoned member (or even an upstart member) of the Berkeley or Princeton faculty, studying Austrian economics is just not a career-enhancing activity.

Theories that they do know, which include New Keynesian, New Classical, and Real Business Cycle Theory, fail to incorporate capital theory in any meaningful way. And although advertised as "new" and "real," none of these theories have more than a tenuous link to current economic reality. Further, these mainstream theories have now begun to merge together into technically demanding and other-worldly constructions called Dynamic Stochastic General Equilibrium Models. For mainstream macroeconomists, the DSGE Models are the wave of the future. They are the vehicles for publications and professional advancement. (Googling "Dynamic Stochastic General Equilibrium" yields more than eighty-thousand results!) Any attention to the Old Austrian theory, then, can only divert their careers in an unrewarding direction.

When the mainstreamers are called upon to make a public statement about the current economy or to make a policy recommendation, they find their DSGE Models wholly unserviceable. And so they simply fall back on the simplest, principles-level version of these complex formal models—which, not surprisingly, is the Old Keynesian theory. Their policy positions are based on the decades-old textbook construction in which earning and spending are locked into a spiral-prone circular flow–and in which countering a downward spiral requires a deficit-financed stimulus package.

Austrian Theory in a Mainstream Straitjacket

The short final section of Bradford DeLong's Singapore lecture, his nutshell rendering of the "Austrian' Story," presents us with a particularly significant case study of the mainstream perspective on Austrian theory. During the several months before his January lecture, DeLong had multiple encounters with the Austrian theory as applied to our current financial crises. The Cato Institute's 26th Annual Monetary Conference (held in November, 2008) was titled "Lessons from the Subprime Crisis." Among the dozen or so papers presented at that conference, the Austrian school was well represented. Although DeLong was not a conference participant, he reacted on December 8 to an online version of Lawrence H. White's conference paper, "What Really Happened," with a critique titled, "Liquidity, Default, Risk." White responded on December 10 with an insightful defense of the Austrian theory. This exchange of ideas was then followed by still more contributions to "The Conversation" stemming from the White paper and including four additional comments by White. (The DeLong-White exchange is accessible through cato-unbound.org, and all the conference papers appear in the Winter 2009 issue of the *Cato Journal*.)

So, what effect did this virtual immersion in Austrian theory have on DeLong's understanding? The answer: little or none. Although his January "nutshell" is just too small to contain much understanding at all, it does contain evidence of the continuing fundamental misunderstandings that are typical of mainstream critiques.

DeLong's explanation of the Austrian view makes reference only to "the economy's capital stock"—that phrase from mainstream macroeconomics that treats capital holistically. Willful or not, DeLong has distorted the Austrian theory by force-fitting it into his mainstream macroeconomic framework. And in DeLong's rendition of the Austrian view, we see that the "overinvestment" which characterized the boom implies that "the economy's capital stock needed to shrink." A two panel diagram showing "boom" and "crash" is used to depict the sequence of overinvestment and shrinkage. The demand for risky assets first rotates up producing the boom and then rotates back down precipitating the crash. The Austrians themselves would claim, instead, that the *malinvestment* (Mises's term) that characterizes the boom implies the need for a *capital restructuring*. In other words, the allocation of resources *within* the capital structure has to be brought in line with post-boom market rates of interest. This restructuring takes some time and is best achieved, in the Austrians' view, by the market itself.

From the Time Dimension to the Moral Dimension

Turning a blind eye to the notions of malinvestment and capital restructuring, DeLong quickly shifts ground from economics to ideology and from F. A. Hayek to Herbert Hoover. (We will take the DeLong's inclusion of Marx in his discussion as pure hyperbole.) DeLong takes the Austrians' call for a market solution (capital restructuring) rather than a government solution (rekindling the boom) as justification for denigrating the Austrians as "liquidationists," a label popularized by DeLong himself in earlier articles and associated in his own thinking with Hayek, Hoover, and Hoover's Treasury Secretary Andrew Mellon. The specific recommendations that Mellon supposedly offered for dealing with the 1929 crash and its aftermath are, by themselves, almost enough to call this association into question:

> Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate. It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people.

Significantly, DeLong's broad-brush use of the term "liquidationism" was criticized by White in a 2008 paper titled. "Did Hayek and Robbins Deepen the Great Depression?" (*Journal of Money Credit and Banking* , 40 June issue). In arguing the absence of a Hayek-Hoover connection, White is convincing on two key points. First, sheer chronology precludes the possibility of Hayek having a timely influence on Mellon and/or Hoover. Hayek's first English-language statement of the Austrian theory was not published until 1931. Besides, a much more obvious basis for Mellon's thinking was the fallacious Real Bills Doctrine, which was written into the legislation that created the Federal Reserve System. Second, there is no evidence that the above quoted passage can actually be attributed to Mellon. It comes from Hoover's *Memoirs* (1952) and reads like a caricatured rendition of Mellon's views—a rendition that sets the stage for Hoover's *rejection* of those views.

For the Austrians, the liquidation that is essential to the economy's recovery is the liquidation of the malinvestments. Resources need to be reallocated. Hence, any government spending program that serves to rekindle the housing boom or even to keep resources from leaving the housing industry is counterproductive. It locks in the misallocated resources. Similarly, restoring macroeconomic health requires the liquidation of many other long-term or early-stage investments whose expected profitability depended upon artificially low borrowing costs.

This needed liquidation does not imply that "a panic would be not altogether a bad thing," a judgment that DeLong also attributes—via Hoover—to Mellon. What Mellon (or Hoover) called a panic, Hayek called a "secondary contraction," meaning a self-reinforcing spiraling downward of economic activity that causes the recession to be deeper and/or longer-lasting than is implied by the needed liquidation of the malinvestment. Hayek argued, in effect, that the "ideal" policy would be one that allows the needed liquidation to proceed at market speed while the monetary authority curbs the secondary contraction (i.e., the panic) by maintaining a constant flow of spending. In terms of the equation of exchange (MV=PQ), Hayek argued that the ideal policy was to keep MV—and hence PQ—constant by increasing the money supply (M) just enough to offset declines in money's velocity of circulation (V). Hayek used the word "ideal" in recognition that the monetary authority may lack both the technical ability and the political will actually to implement that policy. (It would lack the technical ability because it would have no way of getting timely information on the changes in money's circulation velocity; it would lack the political will because pulling money out of the economy when eventually the velocity begins to rise is a politically unpopular thing to do.) But in any case, Hayek and the Austrians generally regarded the secondary deflation as "altogether a bad thing." (In Hayek's later writings, he favored a decentralized monetary system—in which market forces (rather than an ideally managed central bank) would govern changes in the money supply.)

Mellon is charged (by DeLong and many others) of having a "moral objection" to curbing even the secondary contraction. This moral dimension to Mellon's supposed liquidationism tends to get imputed to the Austrian view as well. DeLong quotes Martin Wolf (*Financial Times*, Dec. 23, 2008) at some length on this point. Wolf insisted (with a bow to Keynes) that "we should approach an economic system not as a morality play but as a technical challenge."

It is worth noting here that characterizing the Austrian Story as a morality play is not original with Wolf—and certainly not with DeLong. Most likely, this particular putdown comes form Paul Krugman, whose understanding of Austrian theory rivals DeLong's. Krugman's "Introduction" to the 2006 printing of John Maynard Keynes's *General Theory of Employment, Interest, and Money* contains the following passage:

> Keynes's limitation of the question [about a depressed economy] was powerfully liberating. Rather than getting bogged down in an attempt to explain the dynamics of the business cycle—a subject that remains contentious to this day—Keynes focused on a question that could be answered. And that was also the question that most needed an answer: given that overall demand is depressed (never mind why), how can we create more employment?
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> A side benefit of this simplification was that it freed Keynes and the rest of us from the seductive but surely false notion of the business cycle as morality play, of an economic slump as a necessary purgative after the excesses of a boom. By analyzing how the economy stays depressed, rather than trying to explain how it became depressed in the first place, Keynes helped bury the notion that there's something redemptive about economic suffering."

The Austrian Story is not a morality play. It is a piece of economic analysis. Nor is it just some variation on a theme that can be understood in terms of the analytical framework of mainstream macroeconomics. Rather, Mises and Hayek offered a more encompassing macroeconomic framework, one that illuminates the market mechanisms that allocate resources among the temporally defined stages of production and traces the intertemporal misallocation of those resources to misguided or politically motivated policies of the central bank.

It is important to see that the whole focus of mainstream macroeconomics, and certainly of DeLong's focus, is fundamentally different from the focus of the Austrian economists. The difference, fully recognized by White in his response to DeLong, is captured in Krugman's introduction to Keynes's *General Theory*. Keynes suggested remedies for the ongoing depression without bothering himself about just how the economy came to be depressed in the first place. Throughout the Singapore lecture, DeLong, following Keynes, argues as if it is simply in the nature of capitalism that there are waves of speculation followed by a collective quest for liquidity—for more liquidity than can be readily accommodated in a modern capital-intensive economy. The central bank comes into play only to counter the economy's wealth-destroying gyrations.

Hayek focused on the dynamics of the preceding boom, thinking that the question of how the economy came to be depressed was the most interesting and challenging question, and believing that a satisfactory answer to that question was a strict prerequisite to figuring out how (and how not) to deal with the depressed economy.

An Austrian Perspective on Suffering

There is nothing "redemptive about economic suffering." Krugman, Wolfe, and DeLong are right about that. There is also nothing redemptive about the suffering of the Austrian school in the wake of ill-informed criticism. But the Austrian ideas will continue to suffer as long as mainstream macro continues to develop along its current path. Worse, the suffering of the economy will continue—and intensify—as long as policymakers, following their political instincts and enjoying the support of mainstream economists, opt for ever-bigger stimulus packages to be financed by mushrooming debt.