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TESTING TIMES FOR CENTRAL BANKS – IS THERE ROOM FOR AUSTRIAN IDEAS AT THE TOP TABLE?

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Central banks are facing an unprecedented test in the wake of the credit crisis. We briefly outline prevailing theoretical frameworks and argue that central bankers effectively have a choice between three separate frameworks: Vienna, Cambridge and Chicago. Despite Austrian economics being the least acknowledged we survey increasing exposure in mainstream media, suggesting a role for a more explicit use. We provide implications for policy-makers and claim that Austrian ideas have a place at the top table of policy debate.

Introduction

At a speech in London in 2006 Fynn Kydland surveyed 'the' three ways in which governments can achieve credible monetary policy: the gold standard, a currency board or independent central banks.[2] After taking minimal time to dismiss the first two as either outdated or unsuitable for a modern, prosperous economy the majority of the speech was focused on the latter, and the issue of independence. However, the hegemony of this monetary system belies the relative novelty of its use. Indeed the UK presents an especially peculiar history, given the genesis of independence with the New Labour government of 1997. A decade is a short time and two large coincidences should not be ignored. First, independence has coincided with an unprecedented period of global growth, giving the Monetary Policy Committee (MPC) a relatively easy ride. Second, the political system has been amazingly consistent with the same government in place throughout, and just two Chancellors of the Exchequer (Gordon Brown and Alistair Darling). These two conditions have meant that from its inception the UK system of central bank independence has not been properly tested.

Our main claim in this article is that monetary policy has converged into a blend of two theoretical approaches, despite there being *three* established schools of thought. We feel that there is room at the top table of policy debate for more explicit attention to Austrian ideas, and will survey emerging and prevailing attention amongst policy commentary.

Troubling times to be a central banker

Current economic conditions are proving to be of almost universal concern. In the UK general price levels are rising (with the rise in the consumer price index (CPI) hitting 3.8% and in the retail price index reaching 4.6% in June 2008) whilst output growth is falling (with GDP growth slowing to 0.2% in quarter two 2008), raising the possibility of stagflation. This comes after a serious credit crunch that has led to the nationalisation of Northern Rock and an estimated £50 billion being used as a credit lifeline. Most of the prevailing winds are global and are related to two recent financial bubbles. From late 2000 to 2003 the NASDAQ composite index (of primarily US technology stocks) lost a fifth of its value. This was followed with a bubble in the housing market that burst in 2005/06 leading to a liquidity crisis concentrated on sub-prime mortgages. Although the UK has fewer sub-prime lendings, British banks were exposed through their US counterparts and it is now widely acknowledged that a house price bubble has occurred (the ratio of median house prices to median earnings rising steadily from 3.54 in 1997 to 7.26 in 2007[3]) and that a fall in prices is still to come. Also worrying, we see signs that people are diverting their wealth from financial assets altogether and putting them into hard commodities such as gold or oil.

Although academic attention to developing new models is high, there seems to be a request on the part of central bankers for less formal theory building and more empirical evidence. Alan Greenspan has 'always argued that an up-to-date set of the most detailed estimates for the latest available quarter are far more useful for forecasting accuracy than a more sophisticated model structure' (Greenspan, 2007), which N. Gregory Mankiw interprets to mean 'better monetary policy . . . is more likely to follow from better data than from better models'.[4] But despite the settled hegemony of theoretical frameworks, there is a genuine crisis in some of the fundamental principles of central bank independence. Indeed three points help to demonstrate that some of the key tenets of the independence doctrine are crumbling.[5]

Monetary policy is not independent of political pressures

The UK government grants *operational* independence to the Bank of England, but sets the targets that are required to be hit. This has the potential to mask inflation by moving the goalposts, as Gordon Brown did in 1997 when he switched the target from the retail price index (RPIX) to the narrower CPI. Although the relatively harmonious macroeconomic conditions of the first decade of UK independence has created little room for conflict, the rarity of disagreement between the Bank of England and Treasury also hints at some operational alignment. On the other side of the Atlantic the distinction between *de facto* and *de jure* independence is even more evident, as Allan Meltzer says,

> 'The Fed has done too much to prevent a possible recession and too little to prevent another round of inflation. Its mistake comes from responding to pressure from Congress and the financial markets. The Fed has sacrificed its independence by yielding to that pressure.'[6]

Monetary policy is not merely a technical exercise

The point of removing monetary policy from the hands of politicians was to provide a degree of objectivity and technical competence. Whilst the Treasury is at the behest of vested interests, the Bank of England is deemed impartial and able to make purely technical decisions. In other words, the Treasury targets the destination but the Bank steers the car. But the aftermath of the Northern Rock bailout has demonstrated the failure of this philosophy. As Axel Leijonhufvud says,

> 'monetary policy comes to involve choices of inflating or deflating, of favouring debtors or creditors, of selectively bailing out some and not others, of allowing or preventing banks to collude, no democratic country can leave these decisions to unelected technicians. *The independence doctrine becomes impossible to uphold* [italics in original].'[7]

As these political judgments are made, there will be an increasing conflict between politicians and central bankers.

Inflation targeting is too simplistic

The key problem with the UK is that a monetary system of inflation targeting supposes that interest rates should rise to combat inflation, regardless of the source. Treating inflation as the primary target downplays conflicting signals from elsewhere in the economy. In an increasingly complex global economy it seems simplistic at best to assume such a degree of control. We have seen productivity gains and cheaper imports that should result in falling prices, but a commitment to 2% inflation forces an expansionary monetary policy. As Joseph Stiglitz has said, 'today inflation targeting is being put to the test – and it will almost certainly fail'.[8] He believes that rising commodity prices are importing inflation, and therefore domestic policy changes will be counterproductive. We would also point out the possibility of reverse causation, and instead of viewing rising oil prices as the cause of economic troubles, it might be a sign of capital flight from financial assets into hard commodities (Frankel, 2006). Underlying this point is a fundamental fallacy that treats aggregate demand as being the main cause of inflationary pressure. This emphasis on price inflation rather than monetary inflation neglects the overall size of the monetary footprint, which is 'the stock of saved goods that allow entrepreneurs to invest in more roundabout production' (Baxendale and Evans, 2008). It is actually the money *supply* that has generated inflationary pressures.

The current challenges have thus led to an increasingly unorthodox use of policy tools, with the British government making up the rules as it went along over Northern Rock, and the Fed going to the 'very edge' of its legal authority over Bear Stearns. Paul Volcker made the accusation that 'out of perceived necessity, sweeping powers have been exercised in a manner that is neither natural nor comfortable for a central bank',[9] McCallum's rule and Taylor's rule fall by the wayside as the *New York Times* screams out, 'It's a Crisis, and Ideas Are Scarce'.[10]

Overview of three macroeconomic frameworks

Historically there have been roughly three main ideas that explain macroeconomic fluctuations, and they can be demonstrated with a brief (and highly stylised) overview. The first to emerge stems from Vienna, with the works of Ludwig von Mises and Friedrich Hayek.[11] This focuses on the communicative role played by interest rates, which signal to entrepreneurs the willingness of consumers to forgo current goods for the sake of greater future consumption. When central banks create monetary expansion this disrupts the signal and alters relative prices. Entrepreneurs invest due to low interest rates, but since this is not backed by greater savings the 'boom' is unsustainable. When inflationary pressures caused by the printing of money mean that interest rates rise, a recession is the inevitable consequence. The second is associated with John Maynard Keynes and his followers in Cambridge, England (such as Joan Robinson) and Cambridge, Massachusetts (such as N. Gregory Mankiw and Paul Krugman). This approach shifts attention from demand or supply shocks to emphasise the frictions within a market economy that amplify relatively minor shocks into real (i.e. output and employment) effects. Issues such as price rigidity and capital market imperfections are market frictions that require aggregate demand management to overcome.[12] The third main idea is associated with the New Classical and real

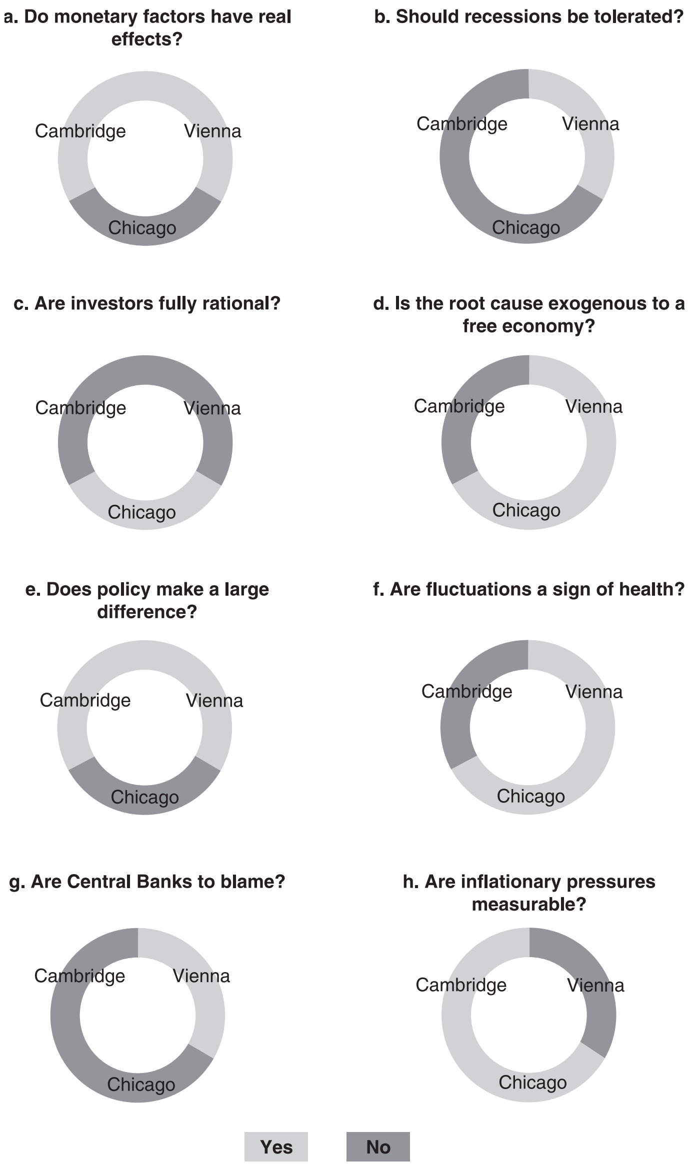

Figure 1: Three frameworks (light = yes, dark = no)

business cycle (RBC) theorists who view cyclical activity as being the outcome of random productivity shocks. Under certain assumptions supply-side shocks (such as energy prices, changes in productivity, regulations, civil unrest) alter the natural rate of output, and the economy efficiently responds.[13]

For simplicity we label these three main frameworks as 'Vienna', 'Cambridge' and 'Chicago', and use doughnut charts to illustrate their similarities and differences (Figure 1). These charts are not intended to be mutually exclusive and jointly exhaustive, and we acknowledge the highly stylised nature (and encourage debate). However, our purpose is to demonstrate that all three frameworks are required to gain a complete overview of the macroeconomic field. Panels (a), (c), (d), (e) and (f) demonstrate that current thinking is a large tent. There is ambiguity about the neutrality of money, the rationality of agents, the extent to which shocks are exogenous, the effects of policy, and whether fluctuations are necessarily a bad thing. Clearly there is room for debate. However, the charts also show the value-added of Viennese ideas, given the panels in which they conflict with both Cambridge and Chicago ((b), (g) and (h)). This presents a theoretical 'blind spot' regarding the necessity of recessions, the culpability of central banks, and the ability of banks to measure inflation.[14]

This demonstrates that the neoclassical synthesis of classical (Chicago) and Keynesian (Cambridge) macroeconomics that underpins central bank philosophy is a necessary but not sufficient use of the ideas available. And as we shall see, current economic conditions are prompting a return to distinctly Austrian (Vienna) ideas across the mainstream media.

Back to Vienna

In 2002 *The Economist* dusted off the Austrian theory during its survey of the global economy, claiming that 'the Austrian cycle may become more common again if, as this survey will argue, financial liberalisation has made bubbles in credit and investment more likely'.[15] That forecast looks prescient given subsequent events, and a year later was further utilised:

> 'America displayed many of those [Austrian] features in the late 1990s. Faster productivity growth raised the natural rate of interest, but because inflation was low (and because Austrian economics had long been out of fashion) the Fed failed to lift interest rates by enough. Investment and borrowing boomed.'[16]

Indeed, if the macro diagnosis is a loose-money-supply fuelled misallocation of resources, the analysis is distinctly Austrian:

> 'A more relevant model might be one based on the Austrian school of economics, developed in the late 19th century, when economic conditions were more akin to today's. In Austrian models the main result of excessively low interest rates is not inflation but over borrowing, an imbalance between saving and investment and a consequent misallocation of resources. That sounds like America today.'[17]

This argument has also been made by Kaushik Das, economist at SBI Capital Markets: 'the Austrian Business Cycle theory can be very well applied to explain the current global as well as domestic financial imbalances'.[18] Similarly, John Dizard, writing in the *Financial Times*:

> 'The Fed, with the encouragement and support of the political class, kept rates low so as continually to postpone financial busts over the past decade and a half . . . The Austrian analysis is probably the best one on hand to analyse the present bind of investors and central bankers.'[19]

Aside from economic commentators and the mainstream press, Austrian ideas have been explicitly mentioned at the Bank for International Settlements (BIS). In a 2006 working paper, William White said, 'these pre-Keynesian insights might still have a capacity to enlighten' (White, 2006). He points out that despite falling from prominence due to the focus on aggregate demand following Keynesianism (and resulting quantification of macroeconomics), structural changes in the economy have made the insights of Austrian theory especially relevant today:

> 'financial liberalisation has increased the likelihood of boom–bust cycles of the Austrian sort. Moreover, integration of big countries into the world economy and the liberalisation and globalisation of the real

> economy, as discussed above, appears to have had material effects on the inflation process and the transmission mechanism of monetary policy.'
> (White, 2006)

Indeed, the 2007 annual report of the BIS is a highly 'Austrian' account emphasising lurking inflationary pressures.

It would be absurd to claim that Austrian ideas are becoming universally accepted; however, it is telling that commentary from media such as *The Guardian* – who are ideologically opposed to the policy implications – now deem them worth mentioning.[20]

Austrian lessons for central bankers

Thus far we have demonstrated that Austrian ideas are neglected by the orthodox treatment of economic fluctuations, but current conditions are prompting increased attention. We now build on this – and demonstrate the need for Vienna to join Cambridge and Chicago at the top table – by outlining the key implications for policy.[21]

Central banks are responsible for inflation

It is a natural tendency for governments to monetise their debt but this does not alter the fact that those with the keys to the printing press are responsible for the inflation in an economy. By expanding the money supply, central banks try to exchange nothing (paper bills) for something (actual goods) and in doing so dilute the proportion of the money supply that is backed by savings. The Austrian economist Frederic Sautet points out the confusion in New Zealand.[22] Don Brash (Governor of the Reserve Bank of New Zealand, 1988–2002) has advocated a petroleum tax as a means to curb inflation, without acknowledging that the cause of the inflation – the size of the monetary base – is under the control of the central bank. Indeed, viewed this way we can see why Mervyn King's claim that 'the objective is not to protect the banks but to protect the public from the banks'[23] is like a drug producer offering to protect heroin addicts from their dealers.

The Austrian position that central banks are to some degree culpable is widespread. For example, the distinguished monetary historian Anna Schwartz (Chicago school) said: 'there would never have been a sub-prime mortgage crisis if the Fed had been alert. This is something Alan Greenspan must answer for'.[24] The Harvard (Cambridge) economist Jeffrey Sachs concurs:

> 'the US crisis was actually made by the Fed . . . the Fed turned on the monetary spigots to try to combat an economic slowdown. The Fed pumped money into the US economy and slashed its main interest rate . . . the Fed held this rate too low for too long.'[25]

And even the former Governor of the Bank of England, Eddie George, has admitted to a Treasury Select Committee,

> 'We knew we had pushed it [consumer spending] up to levels which couldn't possibly be sustained into the medium and long term. But for the time being, if we had not done that, the UK economy would have gone into recession just as the United States did . . . My legacy to the MPC, if you like, has been "sort that out".'[26]

The threat of deflation should not dictate monetary policy

The chief reason why central banks have been so loose with their monetary policy is their fears over deflation. This stems from the perceived lessons of the Great Depression and the consequences of shocks to aggregate demand. However, deflation might not always be so troublesome. As previously mentioned, productivity gains and cheaper imports are relatively benign phenomena, and as *The Economist* says:

> 'Central banks have been slow to grasp the fact that the rapid integration of emerging economies into the global market system requires them to rethink their monetary policy. If they fail to recognise benign deflation created by positive supply shocks, then excessively loose monetary policy will fuel not only financial bubbles but also bigger current-account imbalances.'[27]

Inflationary pressure is not necessarily manifested in visible inflation

The fact that inflation has been relatively low and stable has lured people into thinking that events were benign. But although inflation is always and everywhere a monetary phenomenon, 'there is nothing in Friedman's work that states that monetary expansion is always and everywhere a consumer price phenomenon'.[28] The underlying metaphor is that the economy is a giant airbed, and bubbles arise when there is too much air pumped in by the central bank. However, when the bubble is identified, rather than resolve the underlying cause and allowing the air to leave the system, the central bank targets the specific bubble by pushing down – but this merely transfers the excess to a different part of the economy. The Austrian theory hinges on a signal-extraction problem that prompts entrepreneurial error. Even if an entrepreneur realises that interest rates are artificially low (and therefore funding is not backed by voluntary savings), it is impossible to know for certain what parts of the economy are 'thriving' because of bubble activity and which are thriving for 'real' reasons. Successful ones will cover their exposure and be prepared for a credit crunch, but the marginal entrepreneurs – those who can only afford to borrow funds due to artificially low interest rates – will have been fooled into investing in ventures with no market demand, and the consequences will be painful (Baxendale and Evans, 2008).

Interest rate changes are not the smoking gun: better measures of the money supply are required

The question therefore is what indicators are necessary for the airbed economy? In the same way that changes in the price of oil reveal the underlying demand and supply the central bank's target rate signals the degree of activity within their trading room but is a cover for the underlying changes; they are not the smoking gun. This requires more attention on the money supply, despite the problems related to measurement. Indeed M4 (a broad measure of the UK money supply) has been growing at 12% for the last two years, and 'Since 2000, the annual growth rates of M4 have been 8.36%, 6.52%, 7.02%,

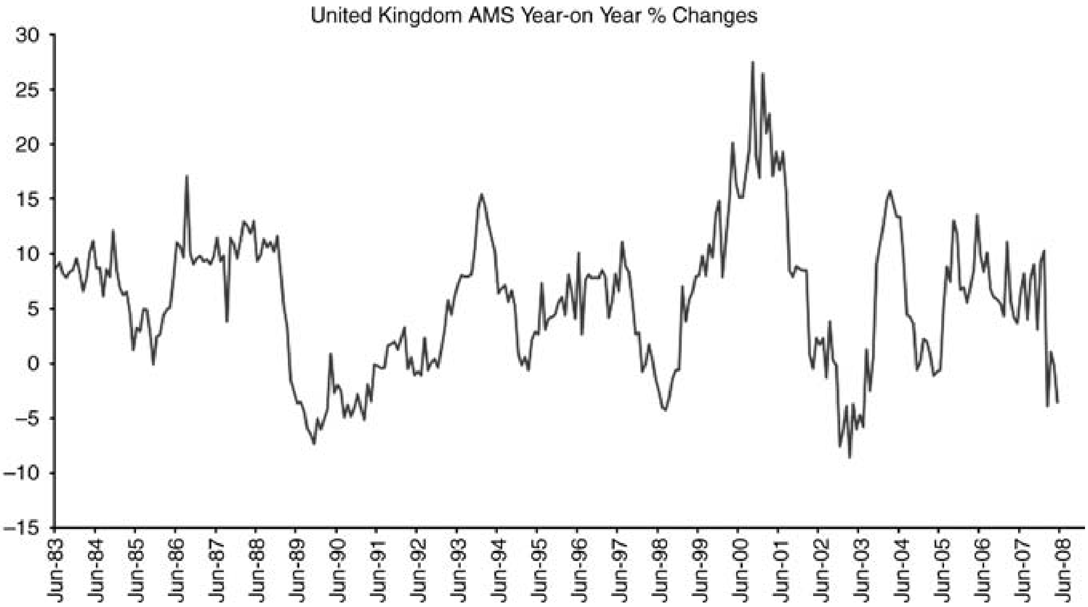

Figure 2: United Kingdom money supply, 1983–2008
Source: M. F. Global, courtesy of Dr Frank Shostak.

7.19%, 9.05% and 12.52%. Interest rate policy has failed to control the growth in the money supply' (Dawson, 2008). Alternative measures of the money supply are becoming increasingly available, such as 'money with zero maturity' (MZM), which focuses on money that is immediately redeemable. More consistent with Austrian theory is the Austrian School of Economics money supply definition (AMS), shown in Figure 2 (Shostak, 2000). Note that although CPI has been relatively stable during this period, the money supply has been rising as high as 25% (in 2000/01), and consistently hitting 10% during the housing boom. The bottom line is that central banks need to be willing to raise rates even if inflation is low. Despite often hearing about 'a new era', a large money supply increase implies inflationary pressure, even if the smoking gun is hard to find.

Recessions should be tolerated

Although the costs of recessions are real, Austrian theory shows that they are an inevitable consequence of a credit-fuelled boom. Policy-makers need to realise that the economic outlook will only improve once existing mal-investments are liquidated and resources transferred to more productive uses. *The Economist* explains the dangers of postponing the inevitable:

> 'The Fed's massive easing after the dotcom bubble burst delayed this cleansing process and simply replaced one bubble with another . . . Delaying the correction of past excesses by pumping in more money and encouraging more borrowing is likely to make the eventual correction more painful. The policy dilemma facing the Fed may not be a choice of recession or no recession. It may be a choice between a mild recession now and a nastier one later.'[29]

Martin Wolf, in the *Financial Times*, suggests, 'The right thing for the Bank to do is to anchor inflationary expectations, even at the risk of a sharp economic slowdown'.[30]

Finally, Allan Meltzer: 'a country that will not accept the possibility of a small recession will end up having a big one when the politicians at last respond to the public's complaints about inflation.'[31]

Central banks must reduce the information asymmetries that they create

Attention to moral hazard has surrounded the issue of regulation, because the prevailing assumption is that bubbles are the consequence of real disturbances, and therefore impossible to identify. As Gerald O'Driscoll points out in the *Wall Street Journal*,

> 'Greenspan argued that asset bubbles cannot be detected and monetary policy ought not to in any case be used to offset them. The collapse of bubbles can be detected, however, and monetary policy ought to be used to offset the fallout'.[32]

This creates a moral-hazard problem because the central bank is saying 'heads you win, tails we lose'. Current Fed Chairman Ben Bernanke endorses this view, and, despite Mervyn King expressing publicly his desire to mitigate adverse selection, it is a fundamental consequence of the prevailing theory. Sub-prime mortgages (and other risky financial activity) have been implicitly subsided by central banks because of the overt promise to intervene in a downturn. *The Economist* outlines the alternative position: 'the Fed should not cut interest rates to bail out lenders and investors, because this creates moral hazard and encourages greater risk taking'.[33] However, the attention on moral hazard ignores the other consequence of asymmetric information – adverse selection. This particular asset bubble has affected the housing market, and in particular the sub-prime section which has concentrated borrowing on precisely those who are most vulnerable. Possibly

> 'the main harm from loose monetary policy is not that it encourages entrepreneurs to behave more recklessly with capital, but that it encourages precisely the people who can't afford capital at the market rate to borrow, and makes them the marginal trader.'
>
> (Baxendale and Evans, 2008)

This goes some way to explain the severity of current events despite sub-prime securities constituting just 1.4% of the global equity market.[34]

Conclusion

There seems to be an increasing acceptance amongst economic commentators that loose monetary policy has fuelled credit bubbles; a too-narrow focus on CPI has prevented central bankers from fully noticing; and the risk of a minor recession should outweigh the threat of future inflation. By providing the context for these ideas we hope this interest is extended to central bankers. In these testing times there should be an open mind for the most appropriate frameworks to influence monetary policy. There is a vacant seat at the top table, and it is time that it was filled.

1. The authors appreciate the helpful comments of an anonymous referee and the editor of this journal. The usual disclaimer applies.
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