

The Importance of Austrian Economics for Central Banks

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Objectives

- Present an overview of Austrian economics and how it relates to other schools of thought
- Identify the relevance for recent central bank dilemmas

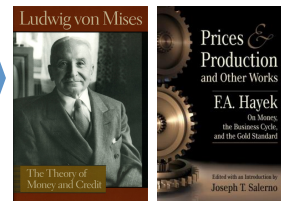
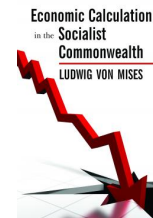
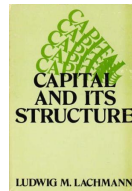
The key contributions of Austrian economics

The American Economic Review
VOLUME XXXV SEPTEMBER, 1945 NUMBER FOUR
THE USE OF KNOWLEDGE IN SOCIETY
By F. A. HAYEK*

Economic
Calculation

Capital
Theory

Monetary
Theory



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The uniqueness of ABC

- If interest rates are pushed below the natural rate:
 - Inflation
 - Unsustainable credit boom
- Problem isn't just a rise in the price level
- By changing relative prices it also has an impact on resource allocation

Cantillon effects:

- Manner in which new money enters the system can have distributive effects
- Koetter, Podlich and Wedow (2017) find that banks with exposure to the Securities Markets Programme (SMP) gained market share
- Unconventional monetary policy therefore has the unintended consequence of effecting regional banking competition

Koetter, Podlich and Wedow (2017) "Inside asset purchase programs: the effects of unconventional policy on banking competition" ECB Working Paper

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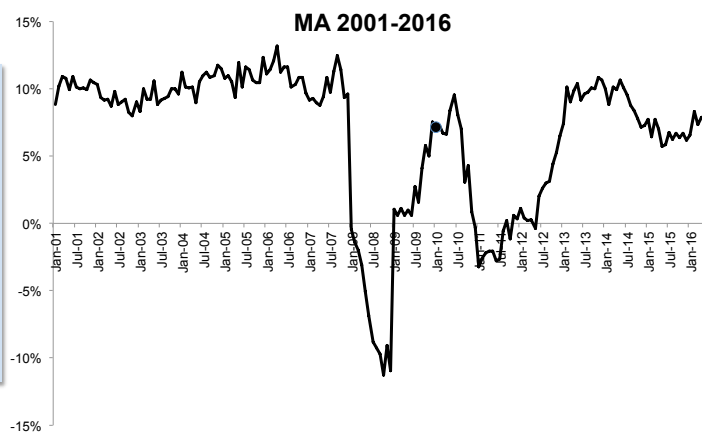
$$MV = PY$$

Competing business cycle theories in light of the quantity theory

- Aggregate demand problem:
 - Monetarists: contraction in M
 - Keynesians: fall in animal spirits (V)
 - Supply side problem
 - RBC: productivity growth (Y*)
 - Austrians:
 - M should be neutral (no inflation and no contraction)
 - Changes in V should be accommodated (but how does a monopoly provider assess demand conditions?)
 - Policymakers can *cause* negative V shocks (“regime uncertainty”)
 - Supply shocks should be reflected in P
 - Negative shocks signal resource scarcity so inflation should rise
 - Positive shocks imply increased productivity so prices should fall (benign deflation)
 - Inflation targets will mask this
- ❖ Be skeptical of over aggregation

High money growth preceded the boom

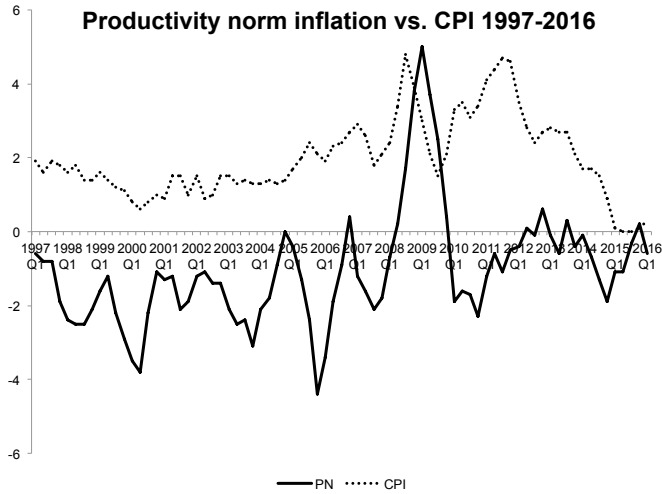
This “Austrian” measure of the money supply was developed after M4 failed to reflect the 2007/08 monetary contraction. It is a narrow measure focusing on cash and demand deposits.



Inflation targets deprive us of benign deflation

Although inflation is always and everywhere a monetary phenomenon, it is not necessarily always a consumer price one:

- It ignores asset prices
- Productivity improvements should manifest themselves in lower prices

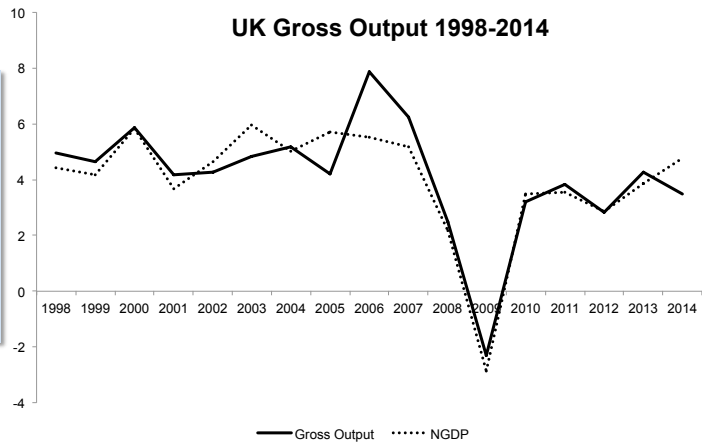


GDP data doesn't capture the whole structure of production

Gross Output (includes intermediate consumption)

The BEA have recently started publishing it.

UK data is only available annually (Supply and Use Tables).



Austrian implications for AD management

- Recessions are costly and take time to correct
 - They are the inevitable consequence of the boom
 - The *boom* is when entrepreneurial errors are made
 - They recession is when they are *revealed*
- To monetarists and Keynesians a recession is a deficiency of aggregate demand
 - Consumers aren't buying *enough* stuff
 - Solution: policymakers stimulate spending
- To Austrians it's a breakdown in coordination
 - Producers are making the *wrong kind* of stuff
- Fiscal or monetary stimulus make matters worse by *preserving* the existing capital structure and *preventing* it from being rearranged in light of the new economic conditions

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Implications of easy money

- "It is also the case that ultra easy monetary policies can eventually threaten the health of financial institutions and the functioning of financial markets, threaten the "independence" of central banks, and can encourage imprudent behavior on the part of governments."
William White
- Examples:
 - Capital malinvestment
 - Destabilizing capital flows
 - Zombie capital
 - Impact on savers
 - Pension deficits
 - Commodity price volatility
 - Dynamics of intervention
 - Regime uncertainty
 - Exit risks

White, William, "Ultra Easy Monetary Policy and the Law of Unintended Consequences", Federal Reserve Bank of Dallas, August 2012

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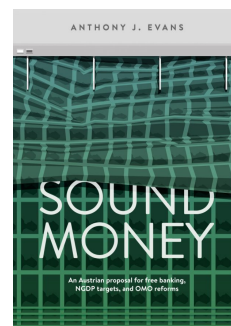
Basic principles between the schools of thought

Chicago	<ul style="list-style-type: none">• Markets always work• Use markets
Cambridge	<ul style="list-style-type: none">• Markets sometimes fail• Use government
Austrian	<ul style="list-style-type: none">• Markets sometimes fail• Use markets

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Scope for OMO reform – make it more market based

- Haldane (2015) presents three possibilities:
 - Revised policy mandate
 - QE for all seasons
 - Eliminate cash
- Selgin (2017) proposed “flexible OMO”
 - The Fed should have a single standing facility for extraordinary as well as ordinary liquidity needs
 - Praises the Bank of England’s product auction mix used for indexed long-term repo operations (ILTRs)
 - He also suggests discriminatory rather than uniform pricing
 - This market mechanism provides useful information about individual banks demand for liquidity, and reveals general market stress. It also makes emergency lending facilities (e.g. the discount window) redundant.



Evans (2016)

Haldane, A., (2015) “How Low Can You Go?” Portadown Chamber of Commerce, Northern Ireland
Selgin, G., (2017) “Reforming Last-Resort Lending: The Flexible Open-Market Alternative” in *Prosperity Unleashed*, Heritage Foundation
Evans, A.J., (2016) *Sound Money* The Adam Smith Institute

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Scope for stress test improvements – make it more market based

- Haldane (2012) refers to FA Hayek and acknowledges that existing regulation has flaws:
 - Greater detail pushes risky behaviour into the same loopholes, which creates systemic danger
 - The more complex the regulations are, the harder it is to anticipate how they'll be gamed and what the downside risks are
- This problem underpins stress tests (e.g. Dowd 2015, 2016)
 - Single “scenario”
 - A game between participants (students) and government (examiners)
 - Encourages standardization with a government backstop
 - Assumes government has the solutions
 - Aim should be to improve information flows between participants and the *market*
 - i.e. experimentation with a market test
 - Aim should be to uncover information

Final thoughts

- Chicago: New Classical/RBC models
 - Cyclical activity as being the outcome of random productivity shocks.
- Cambridge: Keynesian
 - Price rigidity and financial market imperfections mean that minor shocks can have real effects.
- Austrian business cycle theory (ABC)
 - Signal extraction problems combined with capital heterogeneity.
- The former two have merged into a New Keynesian synthesis. **The Austrian voice remains neglected.**

- ❖ **Be methodologically open minded**
 - Be wary of over aggregation/misleading indicators
 - Use scenarios not forecasts
- ❖ **Use markets**