Mises on Interest Rate Suppression

04/27/2016. James Alexander Webb

The current Fed FOMC interest rate targeting policy dilemma both underscores the need for, and detracts from, attention to the 'mission' of central banking itself. Interference with the outcome of unhampered markets, manifested as a bias for repressing interest rates through monetary easing, is the relevant policy issue confronting us today. It was the same issue confronting Mises between the World Wars.

Writing in Vienna in his 1928 Essay, *Monetary Stabilization and Cyclical Policy*, Mises identified the **"false theoretical doctrine"** of driving loan rates below the natural rate of interest (the rate of present-future preferences), as a cause of crises.

The financial sector was complicit: **"…privileged institutions could proceed unhesitatingly in granting of credit…because they could rely on the government's help in an emergency."** In the 19th Century long established commercial standards were routinely suspended in exempting banks from **"general law."** Banks could expand new credit with inadequate liquidity. This became easier under central banking now the platform for systematic money debasement using QE (quantitative easing).

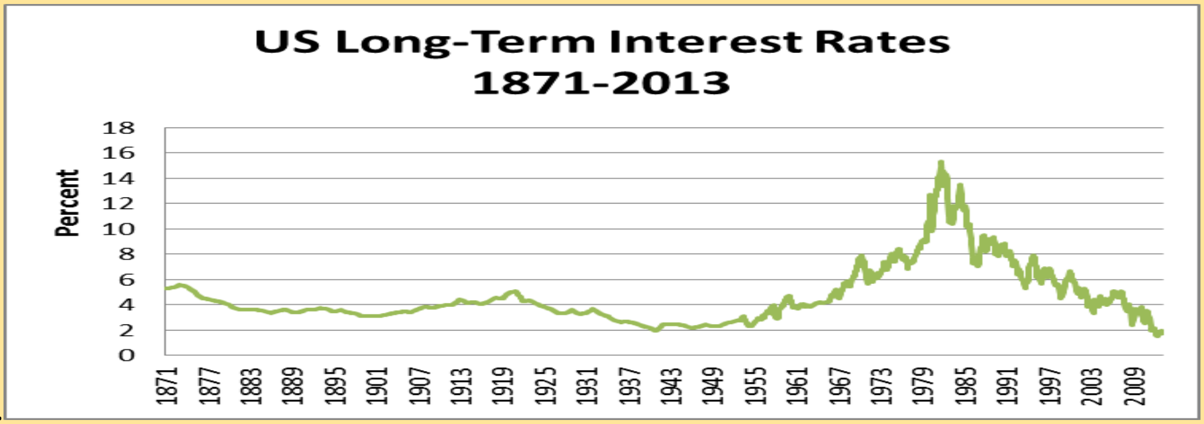
Normally, in unhampered markets, credit derives from saving offset by less consuming. QE fabricates credit; it overrides present/future preferences, represents no new wealth, and is a long-term mismatch for the economy; it misdirects spending.

Bubbles in asset classes can balloon beyond first round effects of credit stimulus alone, but they gain their momentum from rising prices during such stimulus.

Correspondingly, in a boom, credit can expand generally beyond the extent of stimulus alone, (with or without a rise in price indexes) when investor choices shift from liquid to less liquid investments, or with a fall in the *demand for money,* or when institutions similarly increase leverage. Yet market discipline of error-learning and risk aversion provides a check on this process.

But both the fabrication of credit, and the bypassing of such discipline were unpublicized goals of the now *too-big-to-fail* federal financial complex*.* With the 1913 Federal Reserve Act dominant banking interests advanced fractional-reserve banking and gained use of monetary stimulus to truncate corrections.

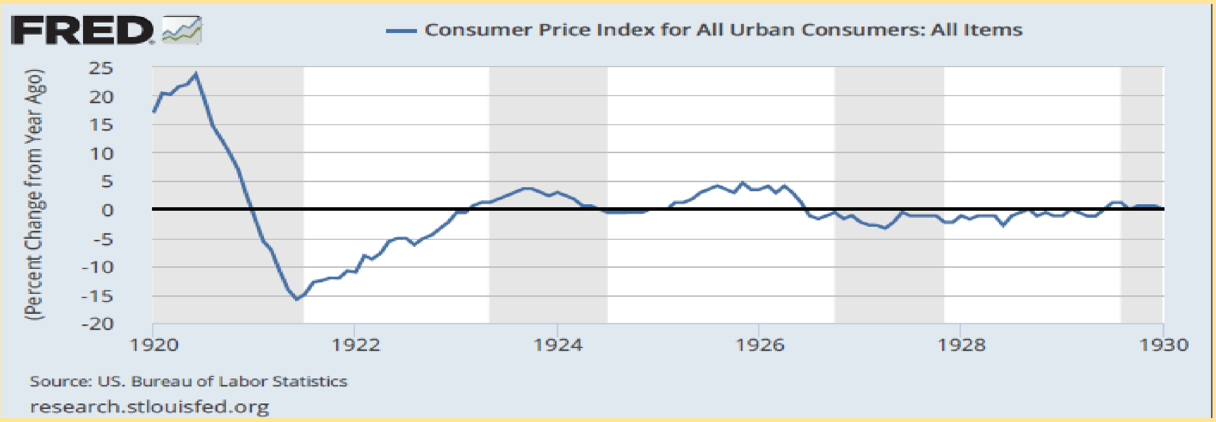
Contrary to purported intentions, crises were amplified and volatility in interest rates increased after 1913 (with further worsening after the 1934 Gold Reserve Act that negated citizens' titles to gold in deposits and currency).



In this environment 'Macro-prudential' policy was nurtured, furthered in stature with econometric trappings and general equilibrium models: never mind that models of interactions between aggregates could only but fail to handle multi-causal human action, and notional, unquantifiable effects from moral hazard and stimulus as indicated above.

Mises theories were hardly considered. The translation from German of Mises' 1912 treatise on money in 1934 was too late for Anglo-American economists faced with explaining the Great Depression. Austrian theory was no convoluted proposition of aggregate spending deficiency. It found root causes in micro-economic imbalances: monetary easing lowers loan rates favoring longer and capital intensive processes, but unsustainably when there is no increased stream of real saving.

By the mid 1920's, Mises foresaw a crash and depression, unlike Irving Fisher or J. M. Keynes, misled by the lack of general price inflation (other than in share prices and real estate); had there not been QE in the 1920's, improved technique and output would have appropriately reduced average prices.



Later, Monetarist Milton Friedman cited the bank-failure driven (early Thirties) contraction of 35% in bank credit in critiquing proximate Fed policy, but Friedman, a proponent of 100% reserves, had in 1959, acknowledged the institutionalized frailty of the official central-bank fractional-reserve system, a point integral to Mises' earlier critique.

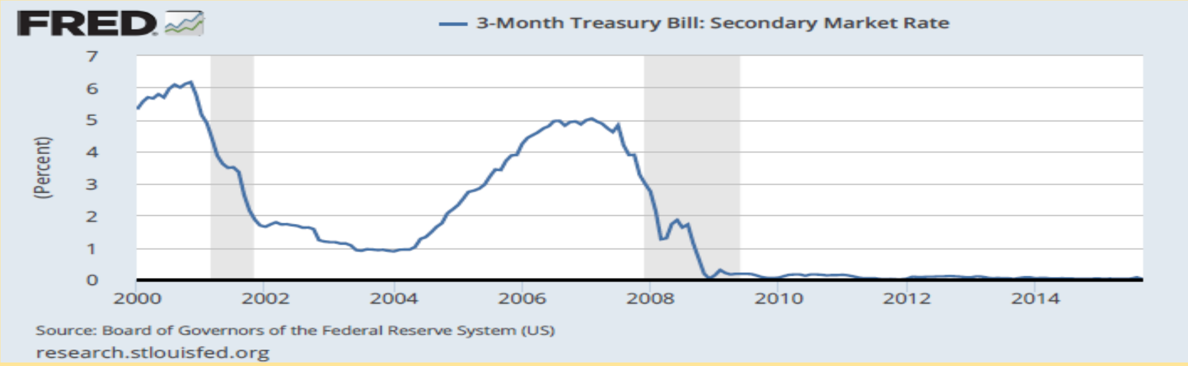
In the September 2008 crises, given credit card payment reliance on real-time solvency of issuing banks, the specter of a contagious shut-down of daily essential commerce moved Bernanke, Paulson et al. to invoke emergency stop-gap measures, including panicked extension of FDIC coverage of deposits from $100,000 to $250,000 (with announced Treasury backing) and an unprecedented expansion of the monetary base. This was not to have happened under central banking, and it revealed that a regime long freed from market discipline is of even less reliability in a digital age.

As for the early 1930's, had remedial Fed action to soften the bank-money contraction been invoked, it would not have undone evident systemic deformation caused by the 1920's crises engendered artificial boom.

Likewise for the Great Recession: the stage was set by decades of mismatched commitments and malinvesting, not from an (avoided) M1 or M2 collapse.

Mises' theory stresses that stable averages such as the CPI, or the overall coefficient of capital, mask underlying compositional distortions during artificial expansions. Lowered (real) rates engendered phantom wealth by increasing valuations of longer term income streams such as in shares and commercial and residential real estate, hence contributing to spending squandered on ephemeral luxuries, yachts, lavish cruises, second homes etc. while professionals and labor over-acquired related specialty skill-sets.

In the early 2000's the Greenspan-Fed cut short-term interest rates to 1%, intensifying investment dislocations. Unanticipated by reigning aggregate-based analysis the reversion back to 5% (in 2006) triggered the crash as losses were revealed. Credit contracted (and money velocity fell)—in step with Mises' theory.



Confidence retrenched; loan-financing for working capital shrank, and without economies of scale in complying with expanded legislated encumbrances, small and start-up businesses suffered most; and given their higher labor to capital mix, hiring plummeted.

Subsequently, business margins weakened which further subdued policy-depressed interest rates, while crony-bailouts reinforced moral hazard in the financial sector.

With no apparent re-assessment, policy makers charged forward with TARP, redoubled QE, and continued deficits, all of which compete for the same factor and capital inputs necessary for Main Street recovery.

The explanation? Mises supplied it back in 1928: **"…the ideology which dominates all influential groups…not only sanctions, but also demands, the expansion of circulation credit."**