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Learning from Mises—How the unhampered market avoids crises and protects wages.

Mises pinpointed the flaw in allowing credit policy to override the unhampered market in his 1928 essay: *Monetary Stabilization and Cyclical policy* (2006, 53ff.). Mises was particularly critical of the bias in policy up to 1928 in favor of lowering interest rates below the market determined levels or below the natural interest rate. He would be just as critical of such bias prevalent today. Just as with other price controls, the attempt to fool the markets with interest rate suppression backfires.

Central bank interference in credit markets has become endemic. Quantitative easing has become a household word. Policy now explicitly aims to suppress the interest rate. Such policy is oblivious to the normal rationing function of credit markets that rely on a market generated rate of interest. This "price" no longer can do its job of balancing the economy. Because of this policy bias, there is continual over-accommodation of credit upswings in the economy, and lack of needed deflating of bubbles and asset classes sensitive to interest rates during corrections.

Moreover, this climate interferes with normally elastic credit availability that rests with the ability of the public to participate in easing of credit by changing portfolio preferences. Decades of rescuing reckless over-lending feeds into the mentality that encourages debt. This has led to periodic overly expansive credit even without a proximate policy increase in the monetary base. Hence the economy is generally prone to bubbles and prolonged speculative exuberance because of the long-term bias to support these excesses. This ability to extend and over-leverage credit on the part of the public has been described by economists as a tendency for a fall in the demand to hold money versus other less liquid financial assets, but here it can be traced to the policy bias for lower interest rates.

The Business Cycle is driven, not from contractions, but from expansions. Expansions set up a critical state of imbalance ending in contraction and crises. This (Austrian) theory explains how the economy becomes imbalanced not only macro-economically overall, but micro-economically between sectors, and hence is unique in this respect as an explanatory theory. Mises was wise enough to not predict when a correction crises would unfold, but could warn of its impending occurrence. "**The economist knows that such a boom must result in a depression. But he does not and cannot know when the crisis will**

appear." (1966, 870). The onset depends on political decisions and other behavior not amenable to quantitative analysis. (Perhaps even more elusive would be timing a fiat currency collapse. Even if individual reactions to simple price signals were distinctly known quantitatively, the timing of such a crises is no more predictable than the next earthquake on a known fault line; reliable predictions are out of reach of mortal men. But in a gradually developing critical state the occurrence of crises, as with earthquakes, is unsurprising.)

Let's look at this process more closely. Narrow monetary aggregates may or may not show change; their increase does not necessarily indicate expansion in credit. Credit expansion can result from the natural elasticity of the system, where for instance, if depositors choose to invest in assets such as real estate or less liquid but more remunerative instruments than cash such as bonds or stocks, or even just money-market accounts, overall credit expansion takes place. And it may look as if policy (which only controls the monetary base) has been unchanged.

Likewise credit contraction may occur despite growth in narrow monetary measures. Recently the monetary base grew the most *after* the bank crises. Despite repeated increases in the monetary base to $4.1 Trillion by 2015, (from $.8 Trillion in 2006), wide measures of credit continued to contract as the new funds served only to shore up long-depleted bank reserves, while suppressing loan market rates.

Driving this behavior of investors in-between crises are expectations that monetary expansion along with bailouts will backstop the financial system; a long history of accommodation and rescue in financial markets has led to this vulnerability.

This state of affairs can contribute to the misunderstanding of the cause of crises. Statistical analysis of data may thus lead economists to see an economy prone to endogenous instability and cyclicality occurring apart from monetary policy.

Austrians know that interactions are not that simple–theory must be antecedent to data analysis and cannot come from data alone.

Take the 1920's and the Great Depression to follow. Measures of consumer price inflation in the 1920's (.38% per annum) gave no warning of excesses. Prominent economists such as Irving Fisher, and John Maynard Keynes were taken completely off-guard. Personal investments of both Fisher and Keynes took the full brunt of losses in the '29 stock market crash (DeSoto, 2006, 200).

In stark contrast, by the mid 1920's the Austrians Mises and Hayek fully expected a crises, the depression was understood as a consequence of the boom. Both were on record warning of impending crises before the 1929 crash (Skousen, 2011, 171-5).

By 1936 Keynes could only see the resultant freezing of investment demand and the liquidity trap (increase in demand for holding money) as causality rather than symptom.

Monetarist Milton Friedman blamed the depression on the contraction in the bank credit component of the money supply, which certainly made matters worse, and which he attributed to policy mistakes by the Fed.

But of this view of cyclicality two points can be made: first, as pointed out by Friedman who was an early proponent of 100% reserve banking (Friedman, 1960, 101), without the regime of fractional reserve banking promoted by the exemption of banks from the discipline of the market for decades up to that point, no such collapse of 1/3rd of the money supply could have occurred in the early Thirties.

Second, in the 2008 crises, the quick action by the Fed and Treasury to back the money supply (by extending the FDIC coverage from $100,000 to $250,000 including money market funds, with Treasury assurances provided as a backing for the FDIC) certainly prevented the risk of an even greater financial disaster this time around. Authorities at least were aware of the even greater vulnerability of a modern economy technologically dependent on trust in accounts, credit cards, etc. As unwise as it is to divest power over the economy in regulators, sometimes they can help put out the fire, even when occurring as a result of their own doing.

More to the point, this monetarist rescue and underwriting action cannot undo systemic damage to the structure of the economy. It could do nothing to prevent a needed readjustment from the over-stimulation of certain sectors in the economy and skewing of the capital structure out of alignment due to interference in the credit markets.

This last cycle followed true to form. As Mises has always made clear in earlier cycles, resources and capital had been irretrievably committed (in the sense of having been irreversibly applied to projects such as structures for specific uses, a shopping center, drill rigs, shipbuilding, for instance) to lines of production not reflecting consumer demand. It is not that the capital coefficient of the economy had been changed, but that labor skills learned and immobile capital and complementary commitments of capital were malinvested.

For this last crises the important point remains that the economy yet suffered a crash in inflated asset values and employment in related sectors, and entered into the Great Recession–the result of the artificial boom policy and endemic biased effort toward pushing interest rates below what would have been their natural level–that only the Austrian cycle theory addressed head on.

The Austrian Business Cycle theory also applied to events before 1913, to crises previous to their exacerbation by the Fed. The Peel Act of 1844 had tried to reign in excessive bank-created credit by preventing banks from issuing private banknotes, but fell short of success by not preventing creation of demand deposits in excess of specie backing. The key is the facility of which credit expansion was able to exceed saving. This partial effort to replicate some of the strictures of a true free-banking regime failed to stem expansion of credit normally tied to the act of saving, hence failing to put an end to periodic crises (Mises, 1971, 369).

Purportedly, the 1933 creation of FDIC was implemented to protect banks and depositors from banking excesses that could be subject to depositor loss of confidence. Congress recognized that this would tend to negate self-restraint on bank lending practices and so enacted Glass-Steagall restrictions on bank investing. The later repeal of Glass-Steagall (1999) was no move toward free-market banking, as widely misconstrued by financial commentators, but rather a move away from that (free-banking) more disciplined environment. This could also be said of the Reagan era Garn-St. Germain bill that unwisely liberalized lending practices for the savings and loan industry.

> **"To be sure, the ideology of free markets was inappropriately applied to the banking industry during the Reagan era and ever since. Under modern institutional arrangements, including deposit insurance and the Fed's bailout window, banks are inherently wards of the state and cannot be safely deregulated." (Stockman 2013, 178).**

The congenital flaw in regulation stems from lobby influence in both legislation and agency oversight of financial risk, supplanting corrective market discipline. Decades of underwriting of over-lending and maturity mismatching in banking and Wall Street investment institutions have produced a moral-hazard culture of finance.

For Mises, the answer is to prudently phase out guarantees that allow the banking industry to over-extend credit, including ending centuries-old crises policies of allowing bank suspension of the obligation to honor deposit withdrawal requests by the public. Mises pointed out that

pressure by banks during crises forced authorities to cave: **"the [1844] Peel Act was suspended in 1847, 1857, and 1866. Such assistance in one form or another has been offered time and again everywhere."** (2006, 126). Added to this has been the decades of bailouts for financial institutions in trouble.

It was just as clear in 1928 as today that the best source of regulation stems from that of the free market actions of the depositors under the tried and true common-law customs governing contract and commerce. Bank lending practices would be restrained by the possibility of the bank-run. Issuing of banknotes would be constrained by competition. The long history of government hampering of market-checks on imprudent behavior and the theoretical bias toward accommodation of credit over-indulgence opened the door to run-away speculative levering of investments. Corrective damping by the regime of accountability imposed by the market was absent:

> **The fact that each crises, with its unpleasant consequences, is followed once more by a new "boom," which must eventually expend itself as another crisis, is due only to the circumstances that the ideology which dominates all influential groups– political economists, politicians, statesmen, the press and the business world–not only sanctions, but also demands, the expansion of circulation credit.** (Mises 2006, 128)

It was noted also by Mises that contrary to common perceptions, those most well-positioned to benefit from low interest rate policies were the wealthy industrialists and corporate owners who constitute the "**proprietary class**" holding the greatest proportion of debt:

> "**The proprietary classes are the owners of big plants and farms, of common stock, of urban real estate and, as such, they are very often debtors. The people of more modest income are bondholders, owners of saving deposits and insurance policies and beneficiaries of social security. As such, they are creditors. Their interest are impaired by endeavors to lower the rate of interest and the national currency's purchasing power.** (2006 [1946], 192)

Both the Great Recession and the Great Depression were accentuated by a coinciding real estate cycle. We know that government sponsored credit agencies, tax exemptions, and interest rate deductions in this sector were highly stimulating to the land-price cycle (averaging 18 years) ending in 2006. Adding to this was the use of real-estate for

highly leveraged collateral-based lending. There should have been no surprise that the business cycle would be amplified, especially since other policy had exacerbated the real estate cycle itself.

The run-up in property values was from locational land appreciation, not on improvements themselves such as buildings and houses. Yet the burden of taxes on improvements, capital, commerce and earnings penalize productive activity. Hence they do little to damp this phenomena and are (unnecessarily) a tax on more than the land. In particular, property taxes, more often fall on improvements which are a result of productive effort, taxes on the site component of implicit rental incomes is minimal. Assessments fail to exclude productive capital improvements such as houses and buildings. In the end, capital gains taxes, and bracket creep income taxation, skew incentives *towards* speculative investments in land site value at the expense of the other factors of production–labor and capital.

Excise, sales, or value added taxes require dead-weight loss accounting inefficiencies and intrusive reporting especially for small businesses for which it is a higher marginal cost, and impute back as lower wages to providers of original means of production in use which falls heavily on labor (Rothbard, 1970, 66-71). Under competition struggling businesses are already pricing as high as the market will bear. They have no choice but to offer lower wages and pass on any new tax to the wage earner who's only option is to do with less or work harder, having no one to pass on his/her burden of the sales tax.

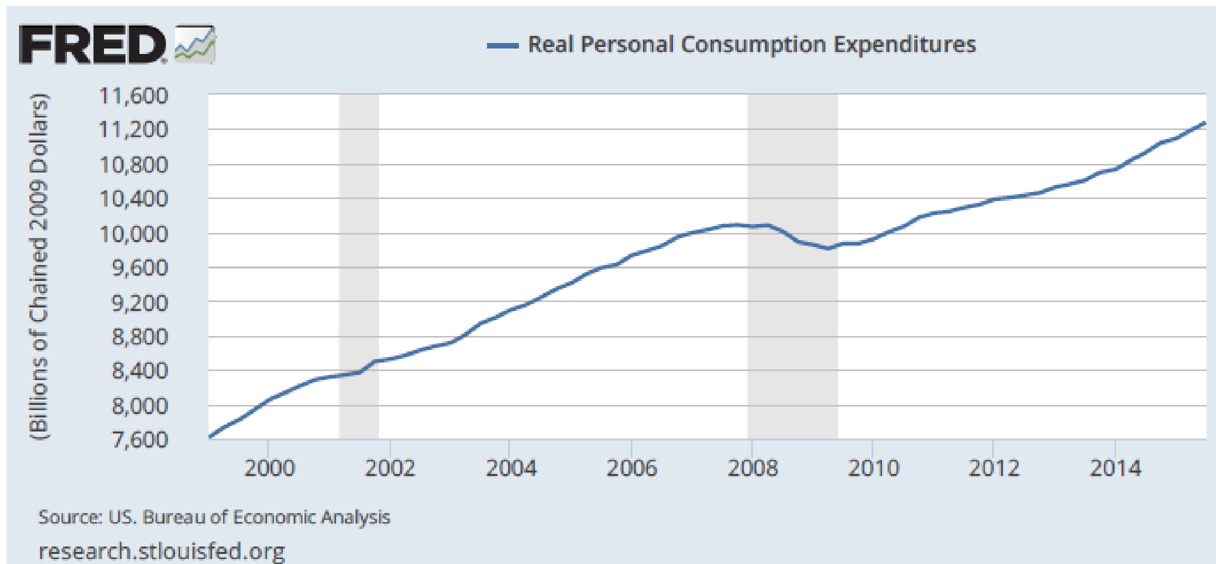
Few commentators think to see that a tax on wage income is higher than it would be if computed on only the "profit" earned by labor. In trading labor for money, the net real gain for the workers are wages less costs to workers in providing labor services. It would not be the entire paycheck. After the impact of all taxes the residual can hardly sustain a subsistence lifestyle for an increasing proportion of workers. Payroll taxes impute entirely to lower wages and so are twice what they seem because the employer's contribution is simply part of what he calculates as compensation to the employee, he must subtract it from what he pays the worker.

Such considerations give weight to solutions empowering the social means, rather than the political means, of regulating the economy. Solutions include phasing out the FDIC, the Fed, budget (fiscal) deficits, and ending pro-active monetary policy and weaning the banks off of dependence on the state with governance by social and commercial customer self-interest. Tax reform and reduction of tax and regulatory burdens would be important for combatting stagnation. By empowering the market and consumer in monetary affairs, the political biases

commonly endemic to top-down management whether by edict, or backed by a showing of hands, can be avoided.

One is lead inescapably to the conclusion that Mises and the Austrians provided analysis useful to those who would champion the welfare of the worker and common man. Mises would tell us that the politicized nature of our monetary system will always have a bias for depressing loan market rates below the natural interest rate. Now ZIRP, zero interest rate policy, is impacting pension fund interest income.

Without institutional reform away from the top-down control of the banking industry and toward the real discipline of the market there will yet be imbalances leading to future crises most acutely felt by small-time investors and the marginal workers. Under popular Keynesian logic economic malaise is caused by lack of consumer spending. However, consumer expenditures rose leading to the crises, from $8 Trn. in 2000 to above $10 Trn. by 2008, certainly not presaging the boom's demise.



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