

## THE SUBPRIME CRISIS

ADRIAN RAVIER AND PETER LEWIN

*ABSTRACT:* This article offers an analysis of the causes of the subprime crisis, explaining that it is not an isolated incident and that we should concentrate our attention on the Fed's monetary policy and pressures on the banking system received from the U.S. government for flexible lending. It also critically examines the Fed's exit strategy and fiscal policies that the government is taking to create jobs and stimulate the economy. We conclude that it should be no surprise if the U.S. economy should fall into a new cycle in the coming years, even though economics does not provides the tools to predict the precise *timing* of it.

*KEYWORDS:* housing bubble, Federal Reserve, savings, deregulation, Austrian, business cycle, Keynes, Leijonhufvud

*JEL CLASSIFICATION:* B25, E32, E58, N12

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## INTRODUCTION

Axel Leijonhufvud, an economist known internationally for his work on the literature of John Maynard Keynes and Keynesianism (Leijonhufvud, 1968), has suggested that the subprime crisis of 2008 more closely fits the Austrian business cycle theory of Ludwig von Mises and Friedrich Hayek, than the Keynesian framework.<sup>1</sup>

In this paper, we provide evidence for that claim. More specifically, we assert the following:

1) that the subprime crisis, or the “housing-bubble” is not an isolated incident. Rather, it is one of a number of related events whose origins can be found in the monetary policy that the Fed has adopted at least since 1980;

2) that when we concentrate on the most recent cycle, (Krugman, 2002), we find that the Fed intentionally replaced the dot-com bubble with a housing bubble, expanding the money supply at a rate of 10 percent (measured by M2), and reducing real interest rates too low for too long;

3) that Greenspan-Bernanke, on behalf of the Fed, asserted, without foundation and contrary to the evidence, that the crisis was not rooted in the politics of the institution they lead, but was rather a global phenomenon, a “savings glut,” which reduced the long-term interest rate naturally;

4) that the popular explanation that blames the deregulation of markets as a cause of the crisis, is also unfounded. In fact, the banking system is one of the most regulated sectors in the U.S. economy. It was, in fact, the excessive regulation of the system, which channeled the easy money policy of the Fed into real estate, thus distorting the physical capital structure of the economy;

5) that the boom we have seen in the housing sector started between 2001 and 2004, and could only have persisted as long as the Fed was able and willing to keep interest rates low, a policy which risks the precipitation of general price inflation. In the face of this threat, the Fed finally raised interest rates, bowing to market pressure as the demand for loanable funds increased. This

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<sup>1</sup> After providing a summary of his understanding of the current crisis Leijonhufvud (2008) argues: “This, of course, does not make a Keynesian story. It is rather a variation on the Austrian overinvestment theme.”

produced the inevitable deflating of the bubble and the onset of crisis and recession, not only in the real-estate sector, but also in the banking-sector which supported it during the boom;

6) that the long-term adjustment process involving as it does adjusting fundamental macroeconomic variables to underlying economic realities has real and enduring consequences. These effects are not “neutral.” Real capital value has been destroyed in the process;

7) that while there is a consensus among economists about expanding the monetary-base as the best “emergency strategy” when facing a possible secondary contraction, Bernanke could have avoided micro-engineering and the favoritism and moral hazard that it implies, and opted for open market operations, rather than the selective rescue of some large companies (those that were “too big to fail”);

8) that accompanying the Fed’s monetary policy, the U.S. Treasury followed an expansionary fiscal policy in an effort to boost employment and thus mitigate recessionary expectations. But the fiscal deficits that the federal government and state-governments has and are accumulating have not delivered the promised employment increases. The fiscal crisis they have produced portend painful, but inevitable, adjustments—expansionary fiscal policies cannot continue and will have to be reversed. We conclude that it should be no surprise if the U.S. economy should fall into a new cycle in the coming years, even though economics does not provides the tools to predict the precise *timing* of it.

## 1. THE FEDERAL RESERVE DURING THE 1980S AND 1990S

In looking for the origin of the crisis of 2008, we should not confine our attention to the excesses of the Federal Reserve during the period 2001–2006. This has been generally the position taken in the recent writings of some economists of the Chicago School (Anna Schwartz, 2009; Allan Meltzer, 2009). We suspect that the conclusion these authors reach is only partially correct. A complete comprehensive study of the crisis must necessarily delve into the monetary policy of the Federal Reserve in the late 1980s and the 1990s (see Roger Garrison [2009a] and Gerald O’Driscoll [2009]).

Garrison (2009a, p. 191) identified this period as one in which the Federal Reserve applied a “learning-by-doing strategy.” O’Driscoll (2009, pp. 175–176), argues that “inflation targeting” began in the 1980s. Volcker’s Federal Reserve term (August 1979 to August 1987) emphasized control of the quantity of money in an effort to control the trajectory of prices, and gave way gradually to focusing on the latter more directly. Greenspan took office in 1987 and continued to focus on prices (the “price-level”). The U.S. economy then experienced a decade of strong economic growth and two financial crises. The first is known as the “savings-and loan (S&L) meltdown,” so-called because most of the U.S. S&Ls failed in this period (1980–1994). The second was a commercial banking crisis, related to the S&L crisis, when 1,600 banks had problems, some of which were rescued.

O’Driscoll (2009) also mentions two stock market crises during the period. There was the Wall Street crash of October 19, 1987, in which investors lost more than \$5 billion in just one day, and the stock market bubble of the dot-com sector which deflated between 2001 and 2002.

Regarding the latter, Nestor Restribo (2002) summarizes the numbers of the spectacular collapse:

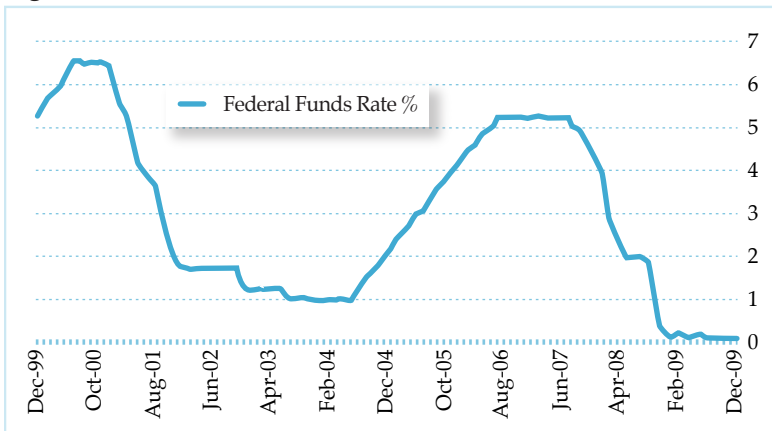
The anguish of thousands of U.S. investors who lost fortunes, first by the bursting of a speculative bubble and more recently by accounting scandals at several companies, can be illustrated thus: in March 2000, at the peak of the casino that was Wall Street in the ‘90s, the total value of the stock market was 17.2 trillion dollars, today it stands at 10 trillion dollars. The loss, in just over two years was \$7 trillion. It is difficult to imagine [the significance of] an amount almost equivalent to the GDP of the entire European Union or of 80 percent of the GDP of the U.S. (our translation)

O’Driscoll (2009) concluded that attempted control, first over money and then over prices, brought about increased money-demand volatility and that “the panic of 2007 is only the latest in a series of financial tsunamis.” The boom-bust pattern described by O’Driscoll is, in essence, the Austrian business cycle theory of Mises and Hayek.

## 2. MONETARY RULES VERSUS DISCRETION: THE PERIOD OF 2001-2007

In the recession of 2001, the Federal Reserve—with Alan Greenspan at the head—aggressively expanded the money supply measured by M2, which year-over-year rose briefly above 10 percent, and remained above 8 percent into the second half of 2003. The expansion was accompanied, as shown in figure I, by discretionary and successive cuts of the federal-funds rate, which started in 2001 at 6.25 percent and ended *the same year* at 1.75 percent. The reduction continued for the next two years, reaching its lowest level in mid-2003, a record 1 percent, where it remained for a year. The real interest rate was negative, indicating that the nominal interest rate was lower than the inflation rate for about two and a half years, something which is unprecedented (White, 2009, p. 116).

**Figure 1. Short-Term Interest Rate, 2000-2009**



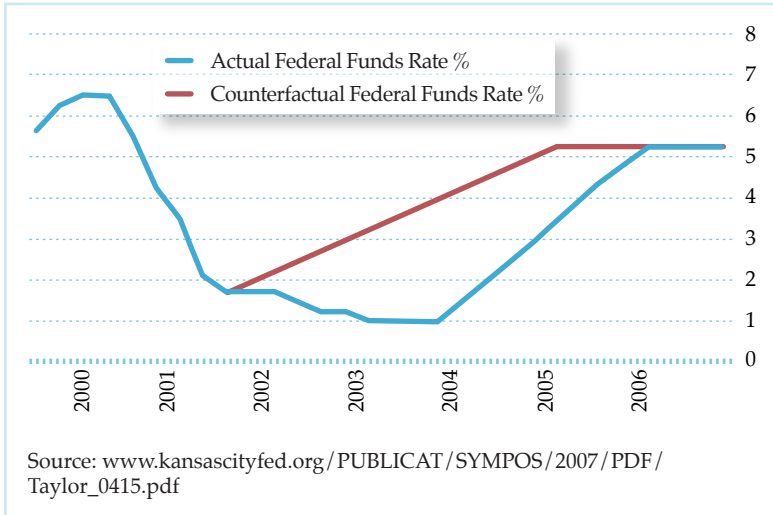
May we assert that the Fed's monetary policy was excessively expansionary? According to White (2009, p. 117), *Yes*, as he illustrates with three monetary rules. First, there is "Hayek's Monetary Rule," which means that the Fed should have maintained nominal income constant ( $MV$  in terms of the quantity theory of money) allowing prices to fall as productivity increased through the decade of the 1990s (also known as the "productivity norm," [Selgin,

1995a, b; 1997: see also Ravier, 2010b and Gustavson, 2010]. Clearly the Fed did not follow this recommendation. The second rule is Friedman's famous rule, which means that the Fed should have increased the quantity of money at a constant low rate. The Fed clearly failed to follow this rule.

The third rule is the Taylor rule. Taylor has shown how far off the Fed was from his rule during the period in question (Taylor, 2008). As a quantitative test of the responsibility of the "Greenspan Fed" in the sub-prime crisis, Taylor (2008, p. 2) shows (Figure II) the hypothetical counterfactual "Taylor Rule" for the U.S. and European central banks in setting short-term interest rates, compared to the actual interest rates set by the Fed in the period 2000 to 2007, indicating an easy-money policy from 2002 to mid-2006.<sup>2</sup>

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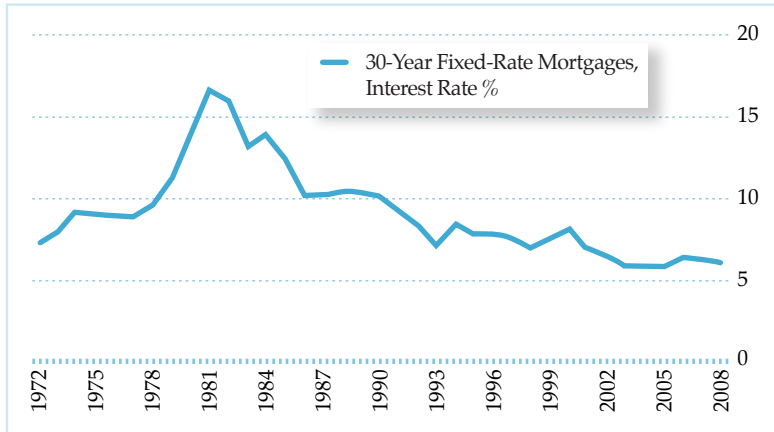
<sup>2</sup> Although the Taylor rule allows us to observe the excesses of the Fed in that period, it has not been without criticism from the Austrian literature. Roger W. Garrison (2009a, pp. 192–193) argues that "[s]ignificantly, Taylor introduced his equation not as a prescription for setting Fed policy but rather as a description of the Fed's past policy moves. [...] In short, the Taylor Rule becomes the baseline for a learning-by-doing strategy. With enough confidence on the part of the Federal Reserve that its past decisions qualify collectively as a 'good performance,' the Taylor Rule becomes a ready formula for it to keep doing what it has been doing."

**Figure 2. Taylor Rule (Counterfactual) versus Actual**

### 3. THE MYTH OF THE “SAVINGS GLUT”

It would be unfair, however, not to refer here to the defense that Alan Greenspan (2005, 2007a, 2007b, 2008, 2009) and Ben Bernanke (2005, 2006, 2007, 2009) have developed in response to these allegations. The two most recent Fed chairmen have denied responsibility for creating the credit bubble which led to the housing bubble and the crisis of 2008. Their defense can be summarized in two arguments: (1) the “savings-glut” theory in which the credit that led to the housing bubble did not originate with the Fed, but was a global phenomenon, a “global abundance of savings” that reduced the “natural interest rate,” and (2) the argument that the monetary base and M2 did not grow too fast.

**Figure 3. Evolution of the Long-Term Interest Rate: Lows for Mortgages 2003–2005**



There is some truth to the first of these two arguments. As noted in Figure III, the nominal long-term mortgage interest rate in the United States actually fell 113 basis points between 2001 and 2004, while inflation fell only 15 basis points. However, as noted above the Fed further reduced its Short-Term Interest Rate 525 basis points, indicating an easy money policy. M2 grew, as noted above, at an unusually high rate for at least two years. White (2009, p. 118) concludes that “Greenspan’s claim that money growth was slow cannot be substantiated.” Cachanosky (2010) illustrates the point:

It is true, as suggested by Greenspan, that the Fed operates on the Fed Funds rate, which is a short-term rate, while mortgage rates are long-term rates. But it is equally true that reducing the Fed Funds generated a transfer from fixed rate mortgages (which depend on the long-term) to variable-rate mortgages (which depend on short-term rates as short as one year); affecting, in the end, the overall level of mortgage loans.

The empirical evidence collected by Cachanosky (2010) “shows the evolution of the base 100 fixed-rate mortgages and adjustable rate mortgages (ARM). It is easy to see that both series move similarly.”

Further evidence bears on Garrison’s questions on an influx of new savings having created downward pressure on the (natural)



rate of interest. According to the “savings-glut” argument, Garrison (2009a, p. 195) notes, “Greenspan was simply following the market rates down.” But this would suggest that the global abundance of savings and its impact on a low natural rate of interest should prevail for some time. These relatively low interest rates and the consequent economic growth they allow, should be sustainable over time, being the result of a secular shift in the savings (consumption) rate. How does one then explain the subsequent rise in the rate of interest? For Garrison, this increase shows that the prior interest rate reductions were not sustainable, and this invites us to look for other causative factors, specifically the policy of the Fed.

George Reisman (2009) goes deeper. His work, based on the Austrian theory of capital, wanting specifically to dispel the “myth of the saving glut,” notes five main arguments: First, if the savings were responsible for the crisis, we should have experienced a decline in consumer spending in the countries concerned (unless there was sufficient economic growth to prevent this). There was no such evidence. Second, an increase in savings implies an increase in the supply of capital goods, higher production and lower relative prices for capital goods and land. These results are inconsistent with the asset bubbles that were experienced. Third, if an increase in savings were responsible for the housing bubble, financial resources ought not to have disappeared *en masse*. Yet the end of easy money policy heralded capital losses and the disclosure of lack of real capital. Fourth, with abundant savings, banks and companies ought to have more capital, not less. Lack of capital is precisely what we would expect to see as the product of mal-investment and over-consumption, which are the result of expansionary credit policy, not greater savings. Fifth, and especially important, in the thirteen years between 1994 and 2006, the rate of U.S. savings, including all the foreign savings that entered the country, never exceeded 7 percent, and in eight of those thirteen years it was 3 percent or less.

#### **4. THE BOOM PHASE OF THE AUSTRIAN BUSINESS CYCLE THEORY**

Accepting then the thesis that the Fed’s monetary policy was expansionary, we focus on the Austrian business cycle theory

interpretation of the ensuing crisis (Mises, 1912; Hayek, 1931; Hayek, 1933; Mises, 1949; Rothbard, 1962; Garrison, 2001). Using this theory, we see Greenspan's and Bernanke's credit expansion producing temporarily optimistic expectations in 2001. Easy monetary policy produces an initial period of economic growth and high corporate profits. We note the short-term agreement between Keynesians, Monetarists and Austrians, on the positive and non-neutral impact on economic activity and employment that such a policy generates (Ravier, 2010a, 2011a and 2011b).

Because of artificially low interest rates, many firms could undertake investment projects that otherwise would not have been viable. It produced what Hayek called mal-investment, which many authors, including Leijonhufvud, call over-investment—sometimes obscuring the structural distortion involved. It was because of favored legislation and regulation that the housing sector received most of the investments that took place through the easy-money policy.<sup>3</sup>

White (2008), Yeager (2009) and Schwartz (2009) explain what were the four major excesses of this regulation favoring the housing-sector:

1) The *Federal Housing Administration* (FHA) was founded in 1934, predicated on the assumption that the mortgage loans made by private companies needed to satisfy certain conditions. For a client to qualify, the FHA originally required, among other things, that the customer put down 20 percent of the money needed to buy the property. Apparently, for bureaucratic reasons, these requirements were systematically reduced. By 2004 the most popular FHA product carried a requirement of only 3 percent down. Congress was working to reduce it to 0 percent. The result was an increase in the rate of default in mortgage payments.

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<sup>3</sup> In a clear attack on those who argue that the crisis was the result of deregulating financial markets (Beker, 2010), Allan Meltzer (2009, p. 27) wrote: "I would challenge anybody to point to something important that was deregulated during the last eight years. Nothing much was deregulated. The last major financial deregulation was the 1999 act that President Clinton signed, removing the Glass-Steagall provisions separating commercial and investment banking." O'Driscoll (2009; p. 167), adds that not only is it a myth that deregulation of financial capitalism was the cause of the crisis, but also that along with the health sector, the financial services industry is the most regulated sector in the economy.

2) The *Community Reinvestment Act* (CRA) is a law passed during the Carter administration in 1977 and expanded in 1989 and 1995. It was created to encourage lending to lower income applicants, who could not otherwise meet the mortgage granting standards. It was part of a deliberate policy to expand access to credit and spread the fulfillment of the American dream of homeownership. Though not very significant in its early years, by 1995 regulators could deny a merger of banks or the opening of new branches, on grounds of not complying with the CRA's provisions. Thus, as White explains, groups like the Association of Community Organizations for Reform Now (ACORN) actively pressured banks to make loans under the threat of registering complaints, and thus reducing the rating of the bank. In response to the new CRA rules, some banks were associated with community groups to distribute millions in mortgages to low-income customers, previously ineligible for credit.

3) Meanwhile, in 1993, private banks began to receive legal challenges from the Department of Housing and Urban Development (HUD) over their mortgage standards. To avoid these pressures and legal problems, banks felt the need to relax the income requirements.

4) Congress then pressured Fannie Mae and Freddie Mac to increase the purchase of mortgages. Roberts (2008), explains:

For 1996, HUD required that 12% of all mortgage purchases by Fannie and Freddie be "special affordable" loans, typically to borrowers with income less than 60% of their area's median income. That number was increased to 20% in 2000 and 22% in 2005. The 2008 goal was to be 28%. Between 2000 and 2005, Fannie and Freddie met those goals every year, funding hundreds of billions of dollars' worth of loans, many of them subprime and adjustable-rate loans, made to borrowers who bought houses with less than 10% down.

In the short term, Fannie and Freddie found that its assets were now more salable, and continued expansion in the purchase of mortgages. White (2008, p. 6) explains: "The hyper-expansion of Fannie Mae and Freddie Mac was made possible by their implicit backing from the U.S. Treasury." To finance the tremendous growth, Fannie Mae and Freddie Mac had to borrow huge sums from the financial market. Investors were prepared to lend money to the two government-sponsored companies, with interest rates

relatively low because of the implicit government guarantee. When they faced financial collapse, and became more conservative, the Treasury explicitly endorsed the debts of Fannie and Freddie.<sup>4</sup>

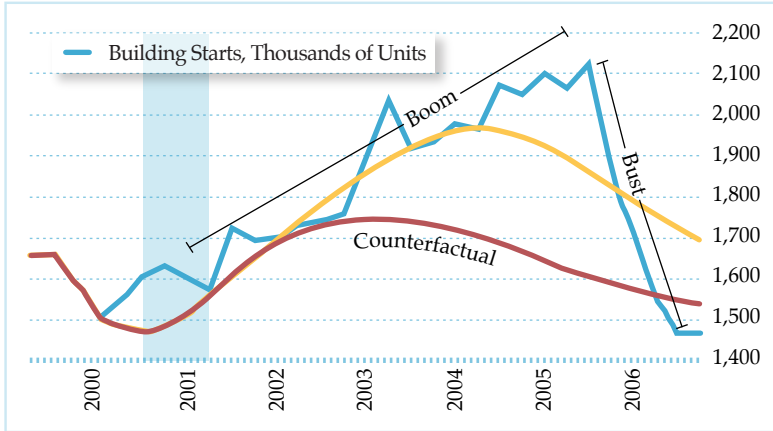
The large increased demand for housing pushed up housing construction (in the U.S., more than 4.6 million new households between 2003 and 2006) and caused sharp increases in the prices of existing houses (the increase was 40 percent between 2002 and 2006).

Empirical evidence collected by John Taylor (2008), reported in Figure IV, shows the boom in building starts (a variable correlated with the price of property). It illustrates that the boom which took place between 2002 and mid-2006 would have been just a hill (according to the posited counterfactual) if the Fed had followed the rule suggested by Taylor.

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<sup>4</sup> Allan H. Meltzer (2009; p. 25) starts his reflections of the financial crisis saying, "First, we should close down as promptly as possible Fannie Mae and Freddie Mac. There never was a reason for those two institutions, other than to avoid the congressional budget process." The case of Fannie Mae and Freddie Mac "is an example of bad government policy." On the effects of Fannie Mae and Freddie Mac on mortgage qualification standards in general see Liebowitz (2008). On systemic risk and the failure of regulation, see Friedman and Kraus (2011).

**Figure 4. Consequences of Reducing Interest Rates. The Boom-Bust in Housing Starts Compared with the Counterfactual, by John Taylor.**



A statement by Alan Greenspan in his book (2007a), shows that the head of the Federal Reserve knew exactly what he was doing. He explains that he was aware that the loosening of mortgage credit terms for subprime borrowers increased financial risk and that the homeownership subsidy initiatives distorted market outcomes. But he believed “and still believes, that the benefits of extending home ownership outweighed the risk.”<sup>5</sup> Over time, some of the credit expansion spilled into other sectors. The bubble was no longer a purely mortgage bubble, but had become a stock-market bubble also. Between 2003 and 2006, the Dow Jones rose 45 percent. As the Austrian theory predicts, in the run-up to the present crisis, the large Wall Street gains prominently featured construction companies like Meritage Homes, CETEX Corporation, Lennar Corporation, and DR Horton Inc.

<sup>5</sup> Interestingly, Paul Krugman (2002), in an article published in the *New York Times*, advised Greenspan to replace the NASDAQ bubble with the housing bubble, as a means of alleviating the crisis of 2001–2002. In his own words: “To fight this recession the Fed needs more than a snapback; it needs soaring household spending to offset moribund business investment. And to do that, as Paul McCulley of Pimco put it, *Alan Greenspan needs to create a housing bubble to replace the Nasdaq bubble*” (italics added).

## 5. THE THEORY OF THE “UNSUSTAINABLE” BOOM

In his *Theory of Money and Credit*, Ludwig von Mises (1953 [1912], p. 366) warned:

Certainly, the banks would be able to postpone the collapse; but nevertheless, as has been shown, the moment must eventually come when no further extension of the circulation of fiduciary media is possible. Then the catastrophe occurs, and its consequences are the worse and the reaction against the bull tendency of the market the stronger, the longer the period during which the rate of interest on loans has been below the natural rate of interest and the greater the extent to which roundabout processes of production that are not justified by the state of the capital market have been adopted.

During the expansion phase, due to the Fed’s “easy money” policy, many banks granted loans at low rates without properly analyzing credit risk. But in 2004, in a speech to the United States Congress, Alan Greenspan expressed the need to raise interest rates to prevent the first signs of inflation and discourage the making of new mortgages to purchase homes. So, before long, the benchmark rate climbed from 1 to 5.25 percent.

Figure IV shows precisely the sharp drop in building starts, which coincides with increased interest rates. The credit crunch reduced the demand for properties and put pressure on those who had bought their homes with a variable rate mortgage. The banks began to experience significant increases in delay of payments, and the effects spread to the stock market, manifesting, from early 2007, in the fall of stock markets around the world. Financial institutions, unable to recover the value of their loans made, liquidated financial assets, exacerbating the collapse in prices.

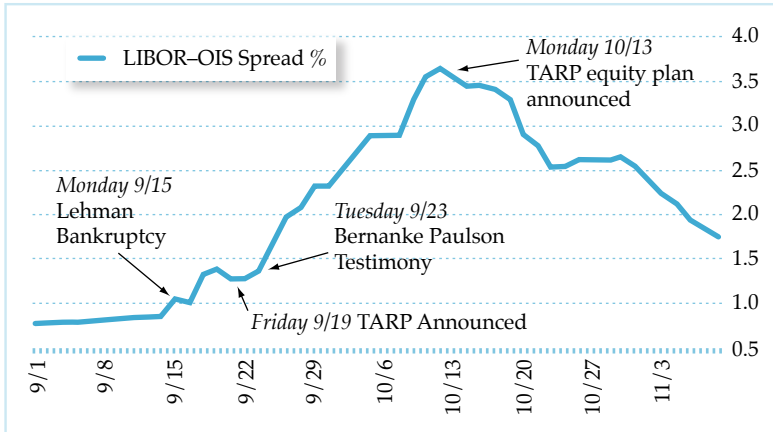
**Figure 5. Default Risks of the American Banks**

Figure V plots the risk of default of U.S. banks, which jumped from 10 basis points in the first half of 2007 to an average of 60 basis points between August 2007 and August 2008, which corresponds to the first stage of the crisis in sub-prime mortgages. That average jumped to 100 basis points when the U.S. government refused to help Lehman Brothers in mid-September 2008 and no less than 350 basis points in mid-October when AIG was rescued, and planted serious doubts in Congress and elsewhere about the consistency of the bank bailout policy.

The main point here is that this confusion and inconsistency was precipitated by the earlier distortionary stimulation of unsustainable capital investments. The boom was unsustainable; the only question was how and when would it end.

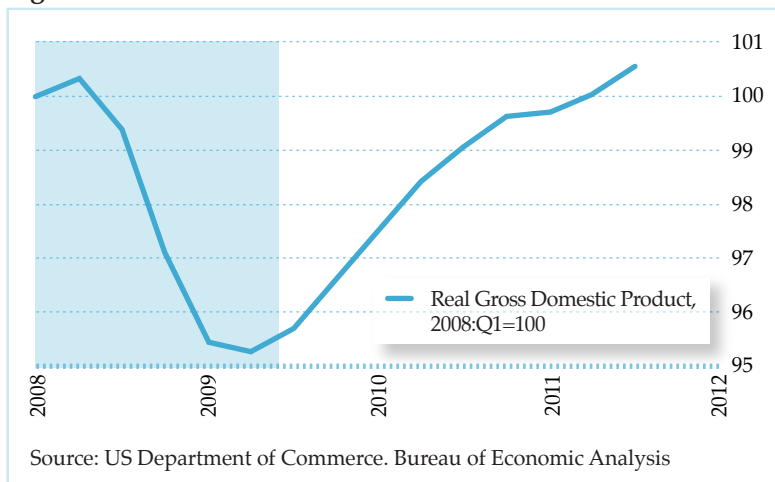
## 6. FROM FINANCIAL CRISIS TO THE ECONOMIC CRISIS

“The fundamental thesis of Hayek’s theory of the business cycle was that monetary factors cause the cycle but real phenomena constitute it,” wrote Machlup (1974, p. 504). During the expansion phase, the artificially low rates created a bias towards longer term investments. Over a period of several years, the investment errors start to accumulate. Long term projects that are no longer profitable may have to be abandoned. The capital in them cannot simply be

moved to other investments.<sup>6</sup> An entrepreneur who invested in a shipyard cannot transform it into an automobile. The capital in the investment has been lost.<sup>7</sup> Capital is heterogeneous (Lachmann, 1978 [1956]). In short, mal-investment means that the economy has receded. That is, it has “destroyed” capital.

In this context, many companies reduce their activities and lay off workers and postpone or abandon the employment of new ones. The result is high unemployment. Figure VI shows the recession of the U.S. economy during 2008–2009, and Figure VII illustrates the increase in unemployment.

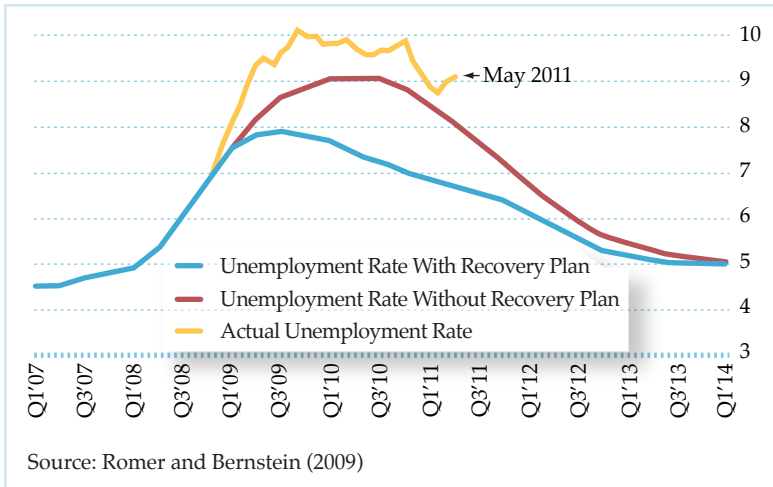
**Figure 6. Evolution of the Real GDP**



<sup>6</sup> The reader may be interested in Young (2012), in which he evaluates empirically the time structure of production in the US, in the period 2002–2009.

<sup>7</sup> O’Driscoll (2009, p.178) offers another example: “During the high-tech and telecom boom, too many miles of fiber optic cable were laid, and not enough miles of railroad track. That was a manifestation of malinvestment. When the history of the housing bubble is written, we will gain insight into the opportunity cost of malinvestment in housing.”



**Figure 7. Unemployment and Obama's Plan**

## 7. THE EXIT STRATEGY OF THE FEDERAL RESERVE

In their famous study, *A Monetary History of the United States, 1867-1960*, Milton Friedman and Anna Schwartz (1963) argued that the Great Depression originated in the mistakes of the Federal Reserve. The problem was not the credit expansion of the twenties, they said, but rather the *secondary contraction* of the money supply produced between 1929 and 1933, causing a great price deflation that destroyed much of the banking system (of the 25,000 banks operating in 1929, there were only 12,000 left in 1933).

What do we mean by “secondary contraction”? According to Garrison (2009b, p. 5), we mean “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.” Friedman and Schwartz concluded, therefore, that the Federal Reserve should have prevented such a crisis by reflation of the money supply.

Ben Bernanke is a student of the Great Depression. He has been influenced by Friedman and Schwartz. But, does their history have any relation to what Bernanke is doing today? In November 2002,

in a speech that Ben Bernanke (2002) offered in honor to Milton Friedman, he made the following statement: "Let me end my talk by abusing slightly my status as an official representative of the Federal Reserve. I would like to say to Milton and Anna: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again."

The truth is that Ben Bernanke is trying to pursue policies that Friedman and Schwartz recommended should have been followed before the Great Depression, that is, expanding the monetary base to avoid a "secondary contraction." Many would say that this is a Keynesian policy, considering the active role that the government and the Federal Reserve took before the crisis. We note, however, that expanding the monetary base when the monetary supply contracts precipitously is an operation with some consensus in the academy. Does this consensus include the Austrians?

On the one hand, no. Jesus Huerta de Soto (2009) for example has noted in a recent article on Ben Bernanke's errors "instead of a crisis that looks like a V, deep and fast (which is what the free market would have produced), monetary and government intervention unnecessarily produced a recession much longer and more painful."

On the other hand, yes. Hayek argued the necessity of the central bank to keep  $MV$  of the quantity equation constant which, in circumstances like the Great Depression, where  $V$  falls precipitously—a situation similar to the present one—this will imply expanding the monetary base to prevent this "secondary contraction." Hayek argued, in effect, that the "ideal" policy would allow 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.<sup>8</sup>

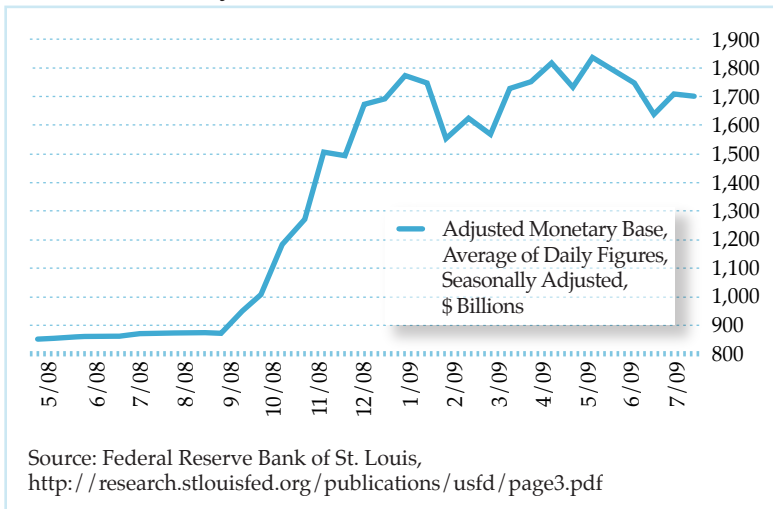
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<sup>8</sup> Garrison (2009b, p. 6) argues that this policy for Hayek would be an ideal, but may not be practical,

...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

It is important to clarify that the increase in monetary supply that Hayek proposed, and nowadays is defended by White (2009) and Selgin (2008), among others, would be nowhere near the magnitude that Bernanke has actually put in place today. (See Figure VIII, which shows the evolution of the adjusted monetary base, which doubled between September 2008 and January 2009.)

**Figure 8. The Solution of the Fed to the Crisis. Double the Monetary Base.**

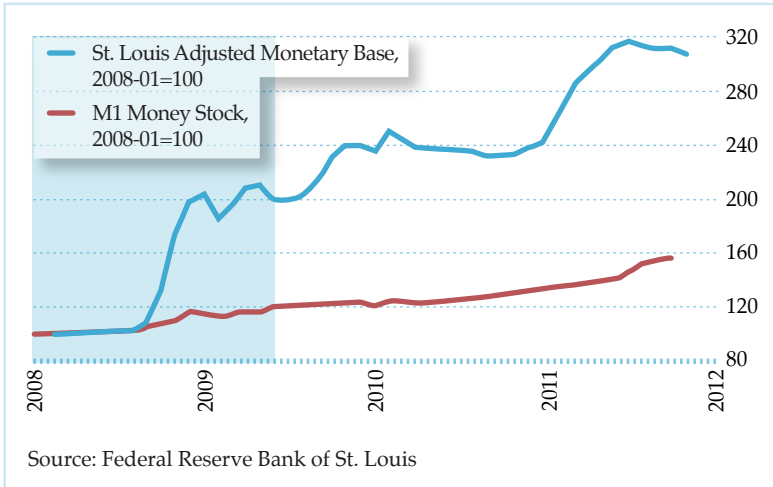


Some economists have defended Bernanke's recent monetary policy. Between 2008 and 2011, even when M0 grew, M1 presented a much more stable picture (Figure VII).

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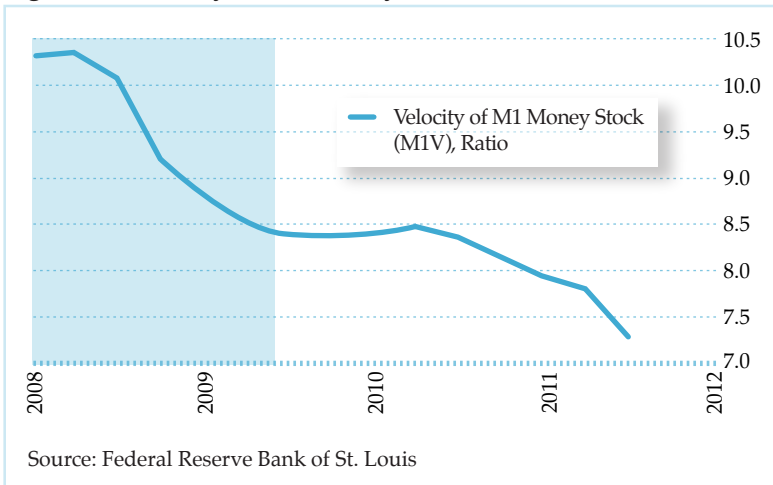
to do.) But in any case, Hayek and the Austrians generally regarded the secondary deflation as "altogether a bad thing." (In Hayek's later writings, he favored a decentralized monetary system—in which market forces (rather than an ideally managed central bank) would govern changes in the money supply.)

**Figure 9. M0 and M1 Monetary Aggregates**



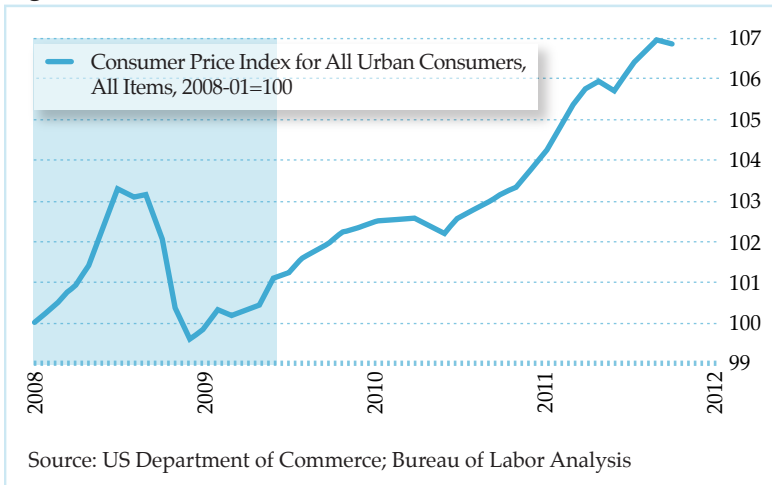
To explain the difference in the dynamics of these two monetary aggregates (M0 and M1), we focus attention on the velocity of the M1 money stock,  $V$  (Figure X).

**Figure 10. Velocity of M1 Money Stock**

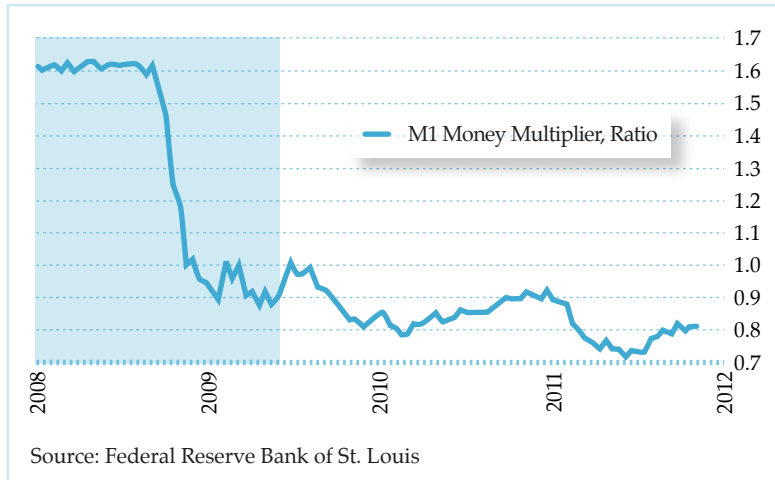


Note, that since September 2008, “V” collapses, but that from 2009 it is more stable. Also in defense of quantitative easing, we note that the CPI indicates that inflation has not shown an alarming rate of increase, presenting between 2008 and 2011 an accumulated inflation rate of only 7 percent (Figure XI).

**Figure 11. Consumer Price Index**



Does this mean that the Fed has acted responsibly? Although the data presented show an evident truth—that M1 growth has been moderate and that inflation is “today” under control—we think it would be a mistake to think that the Fed has acted appropriately. To understand this we need to look at the fall of the M1 money multiplier—a.k.a. a drop in the velocity of the monetary base (Figure XII). The Fed in large part caused this by raising interest on reserves to sterilize the huge M0 injections used to purchase MBSs—many of which were considered “toxic” representing mortgages that were unlikely to be repaid—and partly also by holding down nominal short-term interest rates on other assets.

**Figure 12. M1 Money Multiplier**

Furthermore, there is grave concern about the “exit strategy.” When recovery begins to raise market interest rates well above the rate on reserves, the Bernanke Fed is likely to lack the political will to withdraw these massive excess bank reserves in order to prevent an explosive increase in M1 as the money multiplier returns to normal. We haven’t seen any tightening as the headline CPI inflation rate approaches 4 percent. Instead, we see a pledge to keep rates low until 2013. Thus, there’s a real risk that we will see high M1 growth and inflation.

In addition—and now working on the qualitative side of the problem—the Federal Reserve policy has proceeded by granting the U.S. government discretion in how the monetary expansion is used—risking further malinvestment and effectively destroying the traditional independence of the Federal Reserve System. We would have preferred an expansion of the money supply through open market operations, i.e. buying bonds and without creating any “moral hazard.”<sup>9</sup> Thus, some of the huge companies that

<sup>9</sup> White (2009, p. 120) explains:

Acting as a lender of last resort is merely an aspect of monetary policy: It means injecting reserves into the commercial banking system to

were rescued (those which were deemed too big to fail) would have fallen and others would have been merged or restructured, leading to a natural market adjustment. White (2009) summarizes some of the arbitrary policies being pursued by the Fed since 2008, and argues that this “new Fed,” by late 2008, had given a bailout program of \$ 1.7 trillion, a sum that doubles the program that Congress approved for President Obama when he took over.<sup>10</sup>

Precisely for fear of these types of developments, Hayek eventually came to favor a free banking system and currency competition. But if we assume the continued existence of a central bank in a crisis, a policy of preventing a secondary contraction seems not to be unreasonable, albeit not at all in the way Bernanke has pursued it.

The preceding figures summarize the excesses. It is true on the one hand, explains Huerta de Soto (2009, p. 233), that “the market is very agile and quick to detect errors and spontaneously sets in motion the necessary investment processes (via reduction prices, structural changes and suspension of non-viable investment projects) to meet the necessary and unavoidable restructuring as soon as possible and with minimal cost.” However, a policy such as we have witnessed and are witnessing precipitates new errors. New investment mistakes emerge as a result of a new artificial low interest rate.

Thus, we should not be surprised if the American crisis takes the form of a *W*, rather than a *V*, and the so-called recovery does not stick.<sup>11</sup> In other words, even if the monetary policy of the Federal

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prevent the quantity of money from contracting—when there is an “internal drain” of reserves (bank runs and the hoarding of cash). The “lender” part of the role’s name has long been an anachronism. Central banks in sophisticated financial systems discovered many decades ago that they can inject bank reserves without lending. By purchasing securities, the central bank supports the money stock while avoiding the danger of favoritism associated with making loans to specific banks on noncompetitive terms (Goodfriend and King, 1988). By purchasing Treasury securities it avoids the potential for favoritism in purchasing other securities.

<sup>10</sup> White (2009, p. 121) presents a detailed study of the Fed balance sheet, identifying the institutions that only after 2008 began to receive cash grants.

<sup>11</sup> Axel Weber, the president of the Bundesbank and ECB member, warns of a second wave in the financial crisis. Even Alan Greenspan hinted at the possibility that

Reserve were effective in stopping the mass destruction of jobs in the short term (a dubious proposition), the distortions generated will create an even bigger problem in the future. In addition, as already mentioned, we must consider how the Federal Reserve proposes to “mop-up” the massive increased liquidity that has been created. Once the economy begins to grow again, and the demand for loans increases, monetary rates of growth will be very high unless the Fed devises some strategy for neutralizing all of the excess reserves currently on the balance sheets of the commercial banks. Failure to do so implies inflation and the significant costs it will bring.

## 8. FISCAL POLICY AND UNEMPLOYMENT

Even before taking over as president, Obama obtained a Congressional approval for a stimulus plan of around 800 billion dollars aimed at creating between 3 and 4 million jobs by the end of 2010. The report, entitled “The Impact of the American Job Recovery and Reinvestment Plan” and running only 14 pages, explains that by December 2007 the crisis had consumed 2.6 million jobs, warning that in the absence of the plan it may lose some 3 million more jobs.

Figure VII is part of the report and shows the projected evolution of the unemployment rate with and without the stimulus, assuming that a one percent point decline in GDP would represent around one million jobs lost. The figure shows that in the absence of the plan, the unemployment rate would reach 9 percent, while in the presence of the plan, the unemployment rate would not reach the 8 per cent level.

The red dots in the figure VII are an addition to the report, showing the *actual* unemployment rates in the months following the implementation of the plan. Here we can see that the upward trend in unemployment was significantly higher than projected, having reached a rate of 9.5 percent in June 2009. In the last two

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“the economic recovery could weaken in 2010,” (in an interview with Reuters). “We are getting a recovery in (housing) starts and motor vehicles, but the process doesn’t have legs to it.” Car sales, typically one of the engines of economic recovery, were given a boost by the stimulus plans and the “cash for clunkers” program launched by the U.S. government. These grants encouraged the demand for cars, but, “[T]he sale of new vehicles could decrease once the program runs out public money for junk” (Kaiser, 2009).



years, however, the economy has shown some signs of recovery (Figure VI) and job creation (Figure VII). The sustainability of these jobs created is by no means certain, and ultimately the fiscal situation each year is becoming more delicate (Table I).<sup>12</sup>

**Table 1. US Fiscal Situation**

Year	Public Expenditure (% of GDP)	Deficit (% of GDP)	Public Debt (In US MM)	Public Debt (% of GDP)
1950	18.1 %	-1.1 %	257	93.4 %
1960	17.2 %	0.1 %	291	55.5 %
1970	19.7 %	-0.3 %	389	37.0 %
1980	21.5 %	-2.5 %	930	31.9 %
1990	22.0 %	-3.8 %	3.365	57.6 %
2000	18.8 %	2.3 %	5.662	55.9 %
2010	25.5 %	-8.8 %	14.025	95.1 %

This does not prove that the stimulus package failed in the aim of creating jobs in the short term—though judged by its own estimates, that does seem to be the case. What it does show is that a business cycle that arises as a result of manipulating short-term interest rates leaves a devastating effect on employment in the long term, a proposition some analysts are wont to deny.

## 9. CONCLUSION

History, recent or distant, does not speak to us in one voice. A cacophony of sounds surrounds the message within. The one you hear is often the one you expected to hear. It takes a discerning listener to get it right. We have heard an old message in the disturbing noise of the last three decades. It is this: central bank attempts to engineer the economy, for whatever reason, do so at the enduring expense of the productive efforts of its citizens, and in the process inflict upon them unnecessary economic cycles. The

<sup>12</sup> US public debt in September, 2011 was 100.3 percent of GDP, and this percentage was increasing.

evidence is very consistent with the one we would expect from a credit-provoked business cycle as explained by Mises and Hayek. It is an old story with minor variations, one that sadly applies all too often.

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