



Illustration by BINAY SINHA

# A Hayekian recession with Fisherian consequences

*Fisher blamed over-indebtedness on 'easy money'—a succinct explanation of the current crisis, says DEEPAK LAL*

Which theoretical perspective provides the best explanation for the global financial crisis? Some answers were provided at a recent special meeting of the Mont Pelerin Society I organised as its new President (see [www.montpelerin.org](http://www.montpelerin.org)).

Our starting point must be Knut Wicksell, as most of the macro-economic perspectives on offer hark back to his *Interest and Prices*. Wicksell asked: how could the price level be anchored in a pure credit economy? Bagehot had observed in *Lombard Street* that the whole of the Bank of England's note issue depended on a slender and declining gold ratio. What if this ratio went to zero, asked Wicksell? His answer was that, if the Bank rate were set at the *natural* rate of interest, which balances productivity with thrift, the price level could be kept constant. This is, of course, the theory underlying inflation targeting, as embodied in the Taylor rule. As John Taylor noted, it was the failure of the Greenspan Fed to follow this rule which led to the credit bubble after the dotcom bust.

The reasons for this failure are provided by Hayek's refurbished Austrian theory of the trade cycle. Hayek saw divergences between the Wicksellian natural and market rates of interest as causing booms and slumps. If increased

bank credit led to market interest rates below the natural rate, businesses will undertake relatively more capital-intensive projects with relatively low rates of return. There will also be an unsustainable boom, with more projects undertaken than can be completed, leading to resource scarcities which end the boom. The financial crash which follows will lead to the liquidation of these 'maladjustments', followed by an economic recovery with resources being reallocated in line with inter-temporal consumer preferences and resource availabilities. Whilst broadly accepting the quantity theory of money, Hayek argues that it assumed the absence of 'injection' effects, which even with prices stable could lead to false signals in the pattern of inter-temporal prices, and thence to maladjusted investments. The recent US housing boom, with a stable general price level, provides an example of these 'maladjustments'.

But Hayek's prescription that the slump should be allowed to run its course, came to be disowned even by his LSE circle led by Robbins in the 1930s. As Gottfried Haberler (a close friend and member of Hayek's Austrian circle) noted in his astute appraisal of Hayek's business cycle theory: "Keynes, Robbins, and many others were correct: if a cyclical decline has been allowed to degenerate into a severe slump with mass

unemployment, falling prices, and deflationary expectations, government deficit spending to inject money directly into the income stream is necessary. Moreover, Hayek himself has changed his mind on this point." (*The Cato Journal*, Fall 1986, p. 422).

Though Keynes' General Theory, unlike Hayek's, provides no explanation for the boom preceding the slump, he was right in emphasising "effective demand" failures in the face of a financial crash, and the need for deficit spending. Though not, as advocated by many current Keynesians, through counter-cyclical public works.

Friedman, unlike Hayek, was closer to Wicksell in concentrating on the effects of divergences between the natural and market rate of interest on the *general* price level and not as Hayek's theory presupposes on *relative* prices. With the *real* (natural) rate being determined by productivity and thrift, monetary expansion will only raise *nominal* interest rates through inflationary expectations. Given the natural rate of interest there will also be a corresponding *natural rate of unemployment*. Monetary policy can only lead to transitory deviations from these natural rates, if capital and labour markets are efficient. There is little about credit markets in Friedman, or in his successors of the New Classical and Real Business cycle schools. As

the current New Neoclassical synthesis is based on these models (with some twists of Keynesian 'imperfections'), but contains neither money nor finance, it is useless in explaining or providing cures for the current crisis.

Thus, though Hayek provides the best diagnosis of the cause of the current crisis, neither he nor Keynes provide an adequate explanation of the financial aspects of business cycles, assuming these are endogenous to the fluctuations in the real economy. It is Irving Fisher ("The Debt-Deflation Theory of Great Depressions", *Econometrica*, 1933) who provides the correct diagnosis of the nature and cures for the current crisis. Fisher saw a 'balance sheet recession' as an essential element in the Great Depression. He argued that, whilst there were many cyclical factors behind trade cycles, for Great Depressions the two dominant factors are "over-indebtedness to start with and deflation following soon after" (p.341). Like the Austrians he saw over-indebtedness as caused by "easy money" (p.348). This provides a succinct explanation of the current crisis and pointers to its cure. We have a Hayekian recession with Fisherian consequences.

Having learnt the lessons of Friedman and Schwartz' work on the Great Depression, Ben Bernanke has made sure that the second leg of a Fisherian debt deflation will not occur. But, past and present US authorities have failed to adequately restore the balance sheets of over-leveraged banks, firms and households. US banks urgently need to be restored to health, perhaps through temporary nationalisation as in Sweden in 1992. Whilst, stimulus packages have failed to adopt the obvious means to restore household and firm balance sheets, by a massive across-the-board tax cut accompanied by an equivalent fiscal deficit. It is argued that most of this extra income will be saved, not spent. But this is to be bewitched by the wholly inappropriate Keynesian income-expenditure analysis, which fails to deal with balance sheets. If this Fisherian aftermath of a Hayekian recession is caused by attempts to reduce unsustainable debt, the 'savings' generated by the tax cut (ie reducing liabilities to the government) will allow the necessary deleveraging, without a downward spiral in income and increased bankruptcies. By facilitating households to pay off their mortgage and credit card debts, it will prevent further impairment of bank assets. Instead, we have the dog's breakfast of the Obama stimulus package and a dubious Geithner 'plan' to clean up the banking sector. This, like Nero, is to fiddle while Rome burns.