Coordination Problem

New Spanish Volume of Interviews with Austrians

Steven Horwitz

Below the fold is an interview with me that appears in the brand new Spanish language volume LA ESCUELA AUSTRIACA DESDE ADENTRO (Vol. I) edited by Adrian Ravier. The volume contains interviews with a variety of Austrian economists, past and present. (As the description says: "from Ludwig von Mises to Steven Horwitz!") The second volume will be available in June and it will compile interviews with Henry Hazlitt, Leonard Read, Fritz Machlup, Hans Sennholz, George Reisman, Robert Higgs, Richard Ebeling, Peter Boettke, Larry White, Joe Salerno, Peter Klein and others.

Much of this interview appeared earlier in Free Market Mojo.

**SEEKING MICROFOUNDATIONS FOR MACROECONOMICS:
AN INTERVIEW WITH STEVEN G. HORWITZ**

Professor Steven G. Horwitz is the Charles A. Dana Professor of Economics at St. Lawrence University in Canton, NY. He is the author of two books, *Microfoundations and Macroeconomics: An Austrian Perspective* (Routledge, 2000) and *Monetary Evolution, Free Banking, and Economic Order* (Westview, 1992), and he has written extensively on Austrian economics, Hayekian political economy, monetary theory and history, and the economics and social theory of gender and the family. His work has been published in professional journals such as *History of Political Economy*, *Southern Economic Journal*, and *The Cambridge Journal of Economics*. He has also done public policy research for the Mercatus Center, Heartland Institute, Citizens for a Sound Economy, and the Cato Institute. His current project is a book tentatively titled *Classical Liberalism and the Evolution of the Modern Family*. Horwitz currently serves as the book review editor of *The Review of Austrian Economics* and as an academic advisor for the Heartland Institute and a contributing editor to *Critical Review* and *Journal des Economistes et des Etudes Humaines*.

He has been a visiting scholar at the Social Philosophy and Policy Center at Bowling Green State University and an Affiliated Senior Scholar of the Mercatus Center at George Mason University. He is a past recipient of three fellowship research grants from the Earhart Foundation and an F. Leroy Hill summer fellowship from the Institute for Humane Studies. From 1993 to 1998, he held the Flora Irene Eggleston Faculty Chair at St. Lawrence University, where he also was awarded the Frank P. Piskor Lectureship for 1998-99 and the J. Calvin Keene Award in 2003. From 2001 to 2007, he served as the Associate Dean of the First Year.

Horwitz has spoken to professional, student, policymaker, and general audiences throughout the US and Canada. A member of the Mont Pelerin Society, he completed his MA and PhD in economics at George Mason University and received his A.B. in economics and philosophy from The University of Michigan. Professor Horwitz also blogs for "Coordination Problem".

AR: How did you become an economist?

HORWITZ: Well I had already read some Austrian economics before going to college but I had never thought about becoming an economics major. My interests were in computer science at the time However, in my second semester at the University of Michigan I needed to take a 5th course and thought I should take Economics mostly because I thought I needed to know some in order to defend my already libertarian political views better. I took an Introduction to Economics class and was totally hooked. The economic way of thinking just made total sense to me. The more Economics I took, and the more Austrian stuff I read, the more I became convinced that being an economist is what I wanted to do.

AR: When did you get your first contact with Austrian economics?

HORWITZ: I became a libertarian at age 16 and probably the second or third book I read was Rothbard's *For a*

New Liberty. That book is really a work in libertarianism but it has plenty of references to the works of Austrians. I was soon reading libertarian magazines like *Reas*on and the now-dead *Libertarian Review and Inquiry*, all of which referred to Austrian economics. I believe I first read *Competition and Entrepreneurship* while I was still in high school. This was all around 1980 when the Libertarian Party was also much in the news, so all of that stuff together got me in contact with the Austrian school writers, even before I'd ever taken an actual economics course.

AR: What did you find then in Austrian economics that you didn´t find in mainstream textbooks?

HORWITZ: Given that I was an Austrian before I took any economics, it's hard to answer that question! What got me started in Austrian economics was its defense of the market. I think as I read more Austrian work through college and began to explore mainstream economics, I became increasingly convinced that the Austrians had a more realistic picture of human behavior as well as a more subtle and intuitive understanding of core concepts like competition. I also had an interest in other areas, such as political theory, history and my other major, philosophy. The fact that Austrians drew on other disciplines and seemed to better understand the way that economics was part of the broader social scientific and humanities conversation was very appealing to me as well.

AR: Why do economists have to pay attention to the microfoundations of macroeconomics?

HORWITZ: Because, at the end of the day, all economics is microeconomics. Or as my friend Pete Boettke likes to say: "all economics is the economics of relative prices." There are important things to understand about the movements of economic aggregates and things like the Quantity Theory of Money are, as Mises said, central to our understanding of inflation. However, we should care about those things only because they help us understand the ways in which the systematic effects of inflation and deflation and other interventions that affect money and interest rates reveal themselves as changes in relative prices. The Austrian theory of the cycle is a story about how inflation causes changes in the relative prices of goods, especially present and future goods via the interest rate, that lead to systematic entrepreneurial error and economic discoordination. The cure for the recession that inevitably follows is ultimately further changes in those relative prices such that they return to their undistorted values. As Roger Garrison puts it: there are macroeconomic problems and questions but only microeconomic solutions and answers.

If we don't both ground the movement of macroeconomic variables in microeconomics and understand the way they in turn affect behavior is via relative prices, we have not engaged in an economic analysis.

AR: Ludwig van Der Hauwe wrote that Garrison´s Capital Based Macroeconomics approach "represents a rather radical rupture from traditional and established modes of thought within Austrian economics". What do you think?

HORWITZ: Well I'd like to see the context because I would disagree with it as written. I think Roger's work, which is highly complementary to my own, is solidly within the Mises-Hayek theory of the business cycle and has been used to provide important extensions of that theory into new areas. For what it's worth, a colleague of Kirzner's has told me that when Israel retired a few years back, he told this colleague that Roger's book and my own book were the two most important books written by Austrians since O'Driscoll and Rizzo's. So I'm not sure why Ludwig would think that unless there's some context that I'm missing.

FMM: A particularly interesting statement from your presentation "The 'Great Recession'" is

"Those who wish to blame greed for the crisis need to explain how and why it is that greed seems to causes crises only at specific times, despite the fact that it is omnipresent as a feature of human nature and market economies. … I would argue that the key is the set of institutions through which greed or self-interest is channeled."

Can you discuss the nature of "greed," how it is channeled, and how it can be used to benefit society?

HORWITZ: It's over-simplifying a bit, but there's two general ways to imagine improving the world: changing people or taking people as given and changing institutions. We know that changing people doesn't work and leads to lots of ugliness. There are lots of reasons to think people will be what they are – generally self-regarding, especially when dealing with strangers where we can't know what would directly help others. Given that, we'd like to have institutional arrangements that make it so that satisfying our self-interest forces us to simultaneously, if unintentionally, serve others. Markets do that.

Private property, the rule of law, exchange, markets, etc. all make it so that if we wish to improve our own standard of living, we have to do so by producing value for others in the market. That's the idea of "institutions channeling self-interest." The right institutions, e.g., the market, make it so that pursuing our self-interest is socially beneficial. The wrong ones, such as politics, undermine this. First, when politicians seek their self-interest, there is no process to ensure that it will benefit others. In fact, if anything, it's the opposite: it harms others. Second, the interventions in the market that politicians create often cause the pursuit of self-interest there to be harmful. The Great Recession is an example of exactly that: various regulations and the actions of the Fed made the private sector's pursuit of self-interest to be harmful. Thus it's not self-interest per se that's good or bad, but the institutional context in which it operates that is to be praised or blamed.

FMM: Many economists blame the Federal Reserve, in large part, for the Great Depression. You name the Fed as a culprit in the current recession. Are these simply cases of bad policy decisions, or is the Federal Reserve, as an institution, flawed?

HORWITZ: It is flawed through and through as an institution. As noted above, politicized institutions often lack the right incentives to align self-interest and social benefit. The Fed, like all central banks, faces a major incentive to err on the side of inflation, as it did in the boom that led to the current bust. Inflation benefits the inflator – namely the governments that control or run central banks. It benefits them by reducing the real value of their debt and by giving them a way to incur more debt by simply paying for it with dollars they create. Political self-interest leads to economic chaos.

In addition, central banks face the same sort of knowledge problem that all forms of government control do. How do central banks know in the absence of true market signals how much money to produce? Even if we could overcome the incentive problem noted above, the Fed would still be fairly blind to getting the money supply right. Together, the incentive and knowledge problems can't be overcome by smarter economists running the Fed or by more data. These are structural problems in the institution itself.

FMM: If the Federal Reserve is flawed, can it be fixed or should it be replaced by an entirely new monetary system? How would your ideal monetary system function? What are your thoughts on a Hayekian system of competing currencies, issued by private firms and subject to the laws of supply and demand? Is it possible and practical to return to a pure gold standard?

HORWITZ: I'll tackle these four together. I think the Fed cannot be "fixed." Ideally, I would like to see us move to a completely privatized monetary system. Such a system, as best outlined in the work of Lawrence H. White and George Selgin would involve banks competing to offer both checking accounts and hand-to-hand currency to the public for its use. Importantly, both would be redeemable in some commodity that had value outside the banking system. This might work best with gold as that commodity, but there have been other possible systems proposed. My own view is that gold is the way to go.

But notice a few important things: 1) This is not a "pure" gold standard, if by that one means a 100% reserve system along the lines proposed by Murray Rothbard and others. Banks in this "free banking" system would operate on fractional reserves, just as banks have for pretty much the history of banking. Fractional reserve banking is only a problem when you have a central bank or other government regulations that prevent the competitive market process from working effectively. When banks truly compete, fractional reserves are not a problem. This sort of system is not inflationary (or deflationary) and will not trigger business cycles.

2) A 100% gold reserve system would have problems of its own. On my view, it is unethical from a libertarian perspective as it prohibits banks and their customers from making certain kinds of voluntary contracts, namely

those that involve fractional reserves. It also would hinder economic growth severely. Under fractional reserves, it is much easier for the financial system to intermediate more savings and investment without fraud than it is under 100% reserves. In a 100% reserve system, less capital would get created and growth would be much lower. Such a system is also prone to the problematic form of deflation when faced with a rising demand for money. I don't have the space to develop this argument here, but interested folks can read my 2000 book for more.

3) A White-Selgin type free banking system would be different from Hayek's proposal. His version had no redemption commodity (or "outside money"). It was a proposal for competing fiat monies. Without an outside money, there's no assurance at all that inflation will be kept in check. Hayek thought reputation would do it, but many other folks don't think that's sufficient and that only some outside money like gold can "anchor" the system.

FMM: If the U.S. transitioned from the current Fed-controlled monetary system to a new, more laissez-faire system (be it the gold standard, competing currencies, or any other system), by what process could such a transition successfully occur?

HORWITZ: There would be two possible ways that I can see. One is the evolutionary path. As it stands, more and more of the money people use every day is privately produced as debit cards replace currency and as checking account dollars comprise about 80% of the total money supply. Paper currency is fading. So that's getting us there slowly. The harder part is getting the Fed out of the business of creating reserves. Technology might make private alternatives more feasible than in the past.

The more revolutionary process is further growth in the Fed transparency movement and other rumblings about the Fed. I think for this to work it needs to cross ideological boundaries. I've written some things about the way in which central banks make it easier for nations to engage in militarism and imperialism, and how they are undemocratic. My hope is to engage the left on these issues in a more serious way. Getting a broad coalition that sees central banks as destroyers of economies and funders of imperialism might embolden more politicians to take a serious look at the Fed.

FMM: Returning to "The Great Recession," it is interesting that you, essentially, charge the SEC with creating adverse information problems in securities markets.

"In the late 1960s, after some investment scandals, the SEC created a cartel by authorizing only a limited number of these agencies to be officially-designated raters. With that government-created cartel in place, the agencies slowly shifted from serving investors to serving the issuers of bonds."

Can you elaborate on the nature of the SEC-created cartel and in what ways it is serving the issuers of bonds rather than the investors?

HORWITZ: The SEC authorized those agencies to have privileged status in the wake of some financial problems in the late 60s and early 70s. The thinking, I guess, was to more closely oversee the officially approved firms. The SEC then said that banks could only hold fancy securities rated by one of these three agencies. Once that happened, the big shift occurs. Before that, the agencies served the buyers by, like Consumer Reports, giving them information and ratings about the instruments. But once their approval was needed in order for the securities to be marketed, the sellers started going to them to get the ratings they wanted. The raters then had an incentive to provide good ratings so as to not lose the business to their other two co-cartelists. They also then had reason to eliminate the costs of inter-firm competition by coming to more agreement on how to do things. The results, as you can see, were not pretty.

In the absence of free entry into this market, there was no way to correct the mistakes of the cartelists. There was no Hayekian learning process in place.

FMM: A phrase currently *en vogue* among politicians attempting to expand government power is "systemic risk." Does such risk exist? If so, where does it occur and what (if anything) should be done to protect against it?

HORWITZ: It exists, but it's largely created by government! The biggest systemic risk is when government policies cause firms to be tied together in ways that are problematic. The implicit guarantees to Fannie and Freddie created *huge* systemic risk that markets never would. Same with "too big to fail" in general, as well as Greenspan's promise that the Fed would clean up the results of any asset bubble. Those policies created risks that run through the whole system.

FMM: Do you vote?

HORWITZ: I don't. Although my objections to voting decrease the more local the election is and are less if the issue is a referendum rather than a candidate election. Most of the time, voting for a candidate is about as effective as rearranging the deck chairs on the Titanic. The problems are institutional, structural, and intellectual. Voting does little, especially when the two major US parties have much more in common than differences.

FMM: Over the past several months, there have been various reports of potential moves by other nations to replace the U.S. Dollar as the "world's currency." What is the likelihood of such a move occurring? If it did occur, what would be the consequences for the U.S. economy?

HORWITZ: I'm not enough of an international trade person to say much here. I'd say the likelihood is increasing and will really increase if inflation in the US spikes in the way I would expect it to given all the bank reserves the Fed has created in the last year or so. I'd still put it at less than 50%, but it's not tiny. The consequences would be a fall in the value of the dollar which would throw import and export markets into a tizzy, and damage growth in the process.

FMM: The end of the Great Depression is often credited to either The New Deal or World War II (sometimes both), do either of these events deserve such credit? If not, what were the actual causes of the end of the depression?

HORWITZ: Neither one does. The most recent research on the New Deal indicates that it actually prolonged the Great Depression by interfering with the market processes that were trying to generate recovery and by scaring private investors away from the market through inconsistencies in policy and ongoing threats to private property from the various programs and talk of socialism etc..

The war didn't solve things either, at least not in terms of the private economy. Sure unemployment fell, but that will happen when you draft a few million young men! And GDP rose, but, again, making stuff just to blow it up adds to GDP without improving the real standard of living of the citizenry. Recent studies have shown that private investment continued to languish during the war and that average consumption levels of US households were also stagnant. Remember too that all of the macroeconomic data from that period is distorted thanks to the various price and wage controls in place.

What got us out was the *ending* of the war. That not only removed a whole bunch of wartime controls that interfered with the market, but also brought President Truman to power over a peacetime economy where he was much less hostile to markets than FDR. Those things together, along with the return of lots of productive male labor, was able to generate real private growth by 1947 or so.

FMM: Do you believe an economic recovery is already underway or approaching? What steps are needed to bring about a recovery and a subsequent period of growth?

HORWITZ: I think we are beginning to see a few signs of a very slow recovery. However, the recent GDP report *way* overstates it because most of that change in GDP was due increases in G, which is not about recovery at all. Real recovery is when private investment comes back. The data there are not so reassuring in that it has been very low for several quarters. This may reflect a Great Depression-like hesitance to invest given the uncertainty around policy, especially health care. Unemployment continues to be bad, but it's almost always a lagging indicator during recoveries. It's worth noting that unemployment right now is over a percentage point *higher* than the Obama Administration said it would be *without* a stimulus package. Many of us said the stimulus would make things worse, and it appears we were right.

What steps are needed? Stop taking steps! Repeal the rest of the stimulus already passed but not spent and don't pass another one. Vote down the various health care reform proposals. Stop bashing the private sector for being responsible for the crisis. Stop talking about capping executive pay. Sell off the government's shares in banks and the auto companies. Bottom line: get out of the way and let the market heal itself. It was government intervention that got us in this mess in the first place and history suggests more of that will not solve the problem.

You don't cure a hangover by starting to down the very drinks that caused it.

AR: What is the Hayekian Monetary Rule for central banks?

HORWITZ: I'm assuming you mean the idea of trying to hold MV constant, because I've never heard it called that before! And that does raise a key point: Hayek certainly didn't develop the idea that stabilizing MV was a good thing with the intent of making it a rule for central banks. Rather it was simply part of his theoretical explication of the Austrian cycle theory. He was trying to explain more clearly what was needed to avoid the cycle, in theory. His point was that not all increases in the money supply are bad (regardless of the institutional arrangement) because ones that offset a fall in V (i.e., a rise in money demand) would not cause problems.

It's worth noting that I think you can find passages in Mises where he seems to support the same idea, especially where he defines inflation and deflation in terms of the relationship between the supply of money and the demand for real money balances, as opposed to just absolute increases or decreases in the money supply. No doubt Mises is much more ambiguous on this than Hayek is, but you can find the idea in various places in different works of his.

The interesting question is what set of monetary and banking institutions will come closest to that ideal of a constant MV. Which leads to the next question….

AR: Is it a second best?

HORWITZ: Central banking is never better than a second best solution to the problem of attaining macroeconomic stability. Putting aside the differences among rules or policy advice we might give to a central bank, the ideal path toward avoiding inflation, deflation, and cycles involves eliminating the central bank. My own preference is for a free banking system along the lines of White and Selgin, but I think all Austrians can agree with the claim that the only way to get real progress is to get rid of central banks. I want to be clear about that because some folks in some corners of the internet seem to think that I am somehow soft on the central bank question because I'm willing to at least engage in the discussion of "what should a central bank do given that we have one?" Whatever the validity of my answer to that question, let me be very clear here to say that the first best world is one in which central banks don't exist. If I had the power to do so, I'd push the button and make the Federal Reserve System disappear, or at least phase it out.

So yes, saying that a central bank should try to stabilize MV is no better than a second best. I think it's the best a central bank can do, but that doesn't mean it's very good. Like democracy, it might be awful, but just better than the even more awful alternative rules the central bank could follow and much better than pure discretion.

AR: Do we have knowledge to control MV constant?

HORWITZ: The best arguments for the central bank's ability to do so revolve around trying to target nominal GDP, which amounts to something very similar. But even the nominal GDP targeters (like Scott Sumner) are usually aiming at some growth rate in nominal GDP, which implies that MV isn't constant, and that's the idea that comes out of Hayek. I think targeting nominal GDP/holding it constant is difficult for all the reasons that any central banking policy rule is difficult: central bankers face Hayekian knowledge problems, not to mention more conventional incentive problems. And this is precisely why I think this is no better than a second best. If we really want to avoid macroeconomic disorder, we need to get government out of the banking system and allow the standard competitive process to do its job, the byproduct of which will be stabilizing MV. A stable MV is not something we can "plan" for, rather it's an emergent outcome of the right institutional arrangements in the banking system.

AR: Between September of 2008 and January of 2009, the Fed duplicate the monetary base. Which differences can we find between this Hayekian Monetary Rule and Fed´s policy?

HORWITZ: Simply put, there is absolutely no reason to believe that the demand for money has more than doubled, or that velocity has fallen in half. What we've done is put an enormous amount of spending power into the banking system and only because the banks are reluctant to lend because they economy is so bad, and because the small amount of interest their reserves now earn is apparently sufficient to keep them happy, have we not had significant inflation. My great fear is that once those reserves do start to get lent out, we could quickly see inflation accelerate before the Fed can do much to draw those dollars back in. So I don't see any commonalities at all between what the Fed has done over the last few years and the "Hayek Rule."

What I would say, and have said other places, is that some increase in the money supply was probably justified in light of that rule in the fall of 2008, as there does seem to have been an increased demand for liquidity at the height of the banking problems. But: 1) that increase should have been nowhere near the scale of what the Fed did and has continued to do and 2) it could have been accomplished without the wide array of new and problematic powers the Fed has acquired in the meantime. There is absolutely no "Hayekian" argument that could defend the Fed's actual behavior since September of 2008.

What all of this points to is the challenge of asking political institutions to "do the right thing." Even if we think what the Fed should do is to stabilize MV, telling it to do so does not mean it either can or will do so. Knowledge and incentive problems are widespread in the political process, including central banks, so even if we think stabilizing MV is the best thing for it to do, it can easily turn out that its attempt to do it will lead to a whole bunch of unintended and undesirable consequences.

We would like to thank Professor Horwitz for his time and wish him well in his future academic pursuits.

Posted by Steve Horwitz on April 29, 2011 at 11:16 AM | Permalink

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Congratulations to Adrian, whom I seen working hard and rigorously with my own eyes on this project!

We're all looking forward to the next volume and his future work.

Good work!
NC

Posted by: Nicolas Cachanosky | April 29, 2011 at 12:16 PM
If I may be so bold, for those whose appetites have been simulated by Steve's excellent interview, the interview with me with the title, "Austrian Economics versus the Mainstream," which will appear in that volume two, may be accessed at:

http://defenseofcapitalism.blogspot.com/2010/11/austrian-economics-versus-mainstream.html

Richard Ebeling

Posted by: Richard Ebeling | April 29, 2011 at 04:16 PM
My greetings to Adrian Ravier, who I met at the Austrian Seminar in Rome two years ago.

Posted by: Pietro M. | April 29, 2011 at 04:44 PM

Great book. Congratulations!

About this interview:

AR: What is the Hayekian Monetary Rule for central banks?

HORWITZ: I'm assuming you mean the idea of trying to hold MV constant, because I've never heard it called that before!

Marius Gustavson has written a paper on the topic titled "The Hayek Rule". See:

http://reason.org/files/federal_reserve_monetary_policy_hayek_rule.pdf

Posted by: Max Tyler | April 30, 2011 at 08:11 AM

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