- **Meta**
  - Log in
  - Entries RSS
  - Comments RSS
  - WordPress.com

« Monetary Policy At War With Itself

Bubble or Growth?

July 5, 2009

by Jerry O'Driscoll

In an interview with The Wall Street Journal, German Chancellor Merkel called for an end to risky growth policies built on asset bubbles. "In recent years we've had the Asian crisis, the new economy crisis, and now this great international financial and economic crisis — we can't slide into a crisis every five to seven years." As she notes, however, the central banks of the major economies have implemented "unorthdox" policies to increase borrowing and lending in the current crisis. Those policies risk yet another asset bubble.

Merkel is a physicist by training, not an economist. She chose the laden-term of "sustainable" growth to describe the policy she favors. She clearly has in mind growth fueled by the underlying forces of productivity and thrift, rather than central bank credit and government budget deficits. In Germany, she has adopted the policy of the "thrifty Swabian housewife" — one saves rather than borrows to finance consumption.

Under Alan Greenspan, the Fed promised to reinflate after the collapse of a bubble. And did so. Low average inflation justified continuation of easy money. As Mario Rizzo has noted in a post here, changes in relative prices are as important as the measured inflation rate. Low or zero inflation can mask important changes in intertemporal prices that drive malinvestments (unsustainable investments). Globalization — 2.5 billion Chinese and Indians producing for the market –suppressed measured inflation and further masked changes in intertemporal prices. The housing boom and bust resulted.

At a crucial moment, Ben Bernanke provided the intellectual justification for Greenspan's policies. Not surprisingly, as Fed chairman Bernanke continued them and, indeed, raised the ante: not one-percent overnight interest rates, but near-zero. It is instructive that in the nearly 100 years after the end of the Napoleonic Wars and until the eve of World War I, the Bank of England's Bank Rate never went below 2 percent and was usually well above that level. That was with a gold standard "anchoring" prices and providing real, long-run stability of prices.

Bernanke tells us that the lesson of the Great Depression is that we must never allow deflation. Apparently now deflation also includes falling asset prices. That was not the lesson drawn by Friedman and Schwartz in their classic study of U.S monetary history. On p. 15 of *The Monetary History of the United States, 1867-1960,* they summarize the experience of the Greenback era, which "casts serious doubts on the validity of the now widely held view that secular price deflation and rapid economic growth are incompatible."

The Austrian economists of the 1930s — Mises, Hayek and Robbins — have often been depicted as saying governments shouldn't act to counteract economic downturns. It would be better to say that governments can't act systematically to counteract the effects of the unwinding of an asset bubble or financial boom. The "unorthodox" policies of the Greenspan/Bernanke Fed not only generated recurrent cycles in asset prices, but have now given us the first whiff of actual deflation in many years. The Fed is following Keynes' advice of monetary policy "a outrance," but the downturn continues as markets unwind from past monetary excess.