# Causes and cures of the Great Recession

IEA Discussion Paper No. 40

by

**Steven Horwitz**

**July 2012**

The Institute of Economic Affairs, 2 Lord North Street, London, SW1P 3LB; Tel 020 7799 8900; email iea@iea.org.uk

## About the author

Steven Horwitz is Charles A. Dana Professor of Economics at St. Lawrence University, Canton, New York.

# Contents

Introduction 4

How bad monetary policy generates unsustainable booms 5

Why the housing market and financial system? 7

Can policy cure recessions? 9

Conclusion 12

References 13

# Introduction

For many, the Great Recession and the boom that preceded it are evidence of the failure of the supposed deregulation of financial markets in the last decade and therefore constitute an indictment of capitalism more broadly.[1] However, a closer look at both monetary policy and the effects of other government interventions on the financial system tells a very different story. The causes of the Great Recession lie in misguided government policy, not in the underlying workings of the market. Those policies led to a boom that could not produce sustainable growth and had to end in a bust, as it did. Finding ourselves in the bust necessarily produced by the artificial boom, we should not compound the errors of that boom by seeing more government intervention as the cure. The very distortions created by the policy-induced boom can only be corrected by the decentralised reallocation of resources by entrepreneurs.

[1] Parts of this essay draw on and revise Horwitz (2009).

# How bad monetary policy generates unsustainable booms

One theory of business cycles that can account quite well for the events of the last decade or so is that associated with the Austrian school of economics.[2] According to the Austrian theory, the boom begins when central banks create excessive amounts of money and banks find themselves able to lend more without having acquired new savings from the public. With the new funds, banks lower their interest rates to attract new borrowers. Lower interest rates seem to indicate that the public is saving more and is therefore more patient, justifying the longer-term projects that firms will find profitable at lower rates. When the lower rates are the result of real saving this is true. However, when the lower rates are the result of expansionary monetary policy, they are now disconnected from the public's real willingness to wait.

As producers borrow for longer-term projects under the illusion that the public is willing to wait, capital goods are created, purchased or refitted to engage in these longer processes. Labour is bid away from making consumption goods in order to work on these new projects. Prices and wages are bid up and, even though these projects are not sustainable, they create all the observed measures of a boom: unemployment falls, GDP rises, as do profits. However, the boom cannot last because the growth is not financed by the public's real willingness to save but by the illusion created by the monetary expansion. The inflation causes interest rates to be artificially low and it sends out a false signal about the public's preferences.

As entrepreneurs compete to purchase the capital and labour they need for their projects, they eventually bid the prices of those inputs so high that the producers realise the projects cannot be completed profitably. They abandon these projects, causing the prices of capital and financial assets to fall, along with wages. We also see growing unemployment in those sectors associated with the capital goods industries. So begins the bust phase of the cycle, as stock prices fall, asset prices 'deflate', overall economic activity slows, and unemployment rises. Importantly, the capital goods associated with the longer production processes cannot be instantaneously and costlessly converted over to new uses in the consumption goods sectors. The same is true of labour: workers who lost jobs working, for example, on research and development, will not immediately be able to find a job in, say, the retail industry.

One of the key insights of the Austrian theory is that the boom is when the mistakes are made and it is during the bust that those mistakes are corrected. The false interest rate signal generated by expansionary monetary policy leads to mistakes that must, eventually, be revealed. When the unsustainability of the boom is clear, it is the bust that corrects the mistakes. Unemployed capital and labour reflect entrepreneurs learning of their misallocation and the attempts by workers and owners of capital to find new ways to create value. The recession is the purging and correction of errors induced by the artificial boom.

[2] Key contributions to Austrian business cycle and macroeconomic theory include Hayek (1966 [1933]; 1967 [1935]; 1975 [1937]), Mises (1966, ch. 20), Horwitz (2000) and Garrison (2001).

A look at various measures of the money supply and related interest rates indicates the US Federal Reserve System's expansionary policy and how it drove down interest rates.[3] The Greenspan-era Fed had adopted expansionary policy as part of its attempt to pull the US economy out of the small post-9/11 recession. It created enough new reserves so that the Federal Funds rate fell to the 1 per cent range for a period, and it stayed well below recent historic norms for much of the period prior to 2007. For around two years of that period, the real Federal Funds rate (the nominal rate minus the rate of inflation) was actually below zero, implying that people were being paid to borrow.

From an Austrian perspective expansionary policy is defined as that which pushes market interest rates below the rate consistent with the public's time preferences, known as the 'natural rate of interest'. The challenge this poses is that it is difficult to know the ease of monetary policy because the natural rate of interest is not directly observable (Taylor, 2009, p. 2). Beckworth and Selgin (2010, p. 13) provide a 'crude estimate' of the natural rate, and their technique 'suggests that monetary policy was excessively easy in the aftermath of the dot.com collapse, and that it was so to an extent unmatched since the inflationary 1970s.' Specifically, they show that the estimated natural and actual real Federal Funds rate began diverging in 2001 and, in 2004, the actual real Federal Funds rate was 5 percentage points lower than the estimated natural real federal funds rate. Whatever the imperfections of their estimate of the natural rate, a 5 percentage point difference cannot be explained by such imperfections alone and likely does reflect some degree of expansionary policy. Seasonally adjusted growth in M2, the widely accepted monetary aggregate in the USA, was in the order of 32.5% between 2002 and 2006. With the money supply expanding and interest rates below their natural levels, the evidence for an Austrian-style boom is strong.

[3] The following discussion borrows heavily from Horwitz and Luther (2011).

# Why the housing market and financial system?

In applying the Austrian cycle theory to specific historical episodes, the economist must pay close attention to the other kinds of factors in play that might have led to this particular episode's unique features. Depending on the set of policies, institutions and incentives in place, the excess loanable funds could end up in a number of specific places, although all of them will be ones where the lower interest rate makes longer-term economic activity less costly, and the boom will always be unsustainable. In the recent boom and bust, a series of such factors diverted the excess supply of loanable funds into the housing market, creating an asset bubble there that served as the basis for a set of ill-conceived financial instruments, all of which collapsed in the wake of the bursting of the housing bubble.

The Fed's expansion of credit was chanelled into the housing market as a result of government policies to make housing more affordable that had evolved over several US administrations, starting at least with President Clinton. Among these policies, those dealing with mortgage market government-sponsored enterprises were central. Fannie Mae and Freddie Mac are the key players here in their role as mortgage-market manipulators. Although they did not originate many risky mortgages themselves, they did develop a number of the low down-payment instruments that defined the housing boom. They were also responsible for developing the secondary mortgage market as they purchased mortgages from others and promoted the mortgage-backed securities that became the investment vehicles at the source of the financial market problems.

Both Fannie and Freddie are not 'free-market' firms. They are 'government-sponsored enterprises' (GSEs) chartered by the federal government, and, although technically private up until being re-nationalised in 2008, they were granted a number of government privileges as part of their role in promoting 'affordable housing', in addition to having an implicit promise of being 'too big to fail' should they get in trouble. With such a promise in place, the market for mortgage-backed securities was able to tolerate a level of risk that truly free markets would not as the GSEs did not face the hard profit-and-loss constraint of a genuine market. The bad loans that characterised the boom were mostly originated by banks and mortgage companies and not Fannie and Freddie, but their role as 'Big Players' in the mortgage market changed the incentives facing private actors in ways that made it more likely the latter would make risky loans, knowing they could quickly package them up and sell them off to Fannie, Freddie and others.[4] Fannie and Freddie's immunity from genuine market profit and loss sent distorting ripple effects through the rest of the mortgage industry, allowing the excess loanable funds coming from the Fed to be turned into a large number of mortgages that were riskier than a truly free market would have tolerated.

In addition, even as the credit expansion and distorted reduction in risk were fuelling house purchases and flips, and thereby driving up prices, Fannie and Freddie were under significant political pressure to keep housing increasingly affordable and extend opportunities to historically 'under-served' minority

[4] On 'Big Players' see Koppl (2001).

groups. Many of the mortgage instruments that required no or very small down payments (especially those associated with Countrywide Mortgage) were designed as responses to this pressure. These government policies and regulations were responsible for steering this particular boom in the direction of the housing market. Unlike most past booms where the excess of loanable funds ended up as credit to producers, the government policies that accompanied the credit expansion were responsible for channelling those funds into housing.

The inflation-fuelled increase in housing prices enabled other financial institutions to use the mortgage payments of borrowers as a flow of income that could be packaged into a new instrument and then parcelled out among investors. These mortgage-backed securities were all premised on the belief that housing prices would continue to rise, thereby enabling even those who had small down payments eventually to see their equity grow to the 20% normally thought to be necessary to avoid an unacceptable risk of default. The problem with this scenario was that if housing prices fell, low down payment homeowners would find themselves with mortgages greater than the value of their homes, and the increase in defaults that would result would disrupt the whole flow of mortgage payments and bring the mortgage-backed securities down with them. By 2006, the housing industry found itself increasingly unable to find the resources it needed to build houses at prices that would be profitable and the flow of credit from the Fed began to dry up. Housing prices began to fall and the investments built upon the assumption of rising prices were under threat. The stock market's large drop in the fall and winter of 2008-2009 reflected the growing realisation that the bust was underway and that the future earnings prospects of many firms had dimmed.

The shrinkage of the housing and construction industries in response to falling prices and the reduction in credit led those sectors to shed jobs and dramatically reduce investment in capital. A similar shrinkage took place in the financial sector, especially those areas that had been involved with housing-related assets. These losses in employment and income led to declining demand across the rest of the economy. In addition, the reduction in equity value in homes along with the declines in the value of retirement accounts and other investments caused further shrinkage in demand as households began to try to recoup that wealth through reductions in consumption. The result was the decline in the various macroeconomic indicators that we associate with recession. Although in the USA the recession has been officially over since 2009, the very slow pace of recovery continues to make these issues salient, as the adjustment processes of the bust try to work their way forward.

# Can policy cure recessions?

Given this Austrian diagnosis of the problem, what, if anything, does this perspective have to say about a cure? Unsurprisingly, given the role government played in causing the boom and bust, there will be scepticism that government can do much to cure the problem. The structural incentives of the political process mean that even if there were some number of things government might do to help the situation, we cannot ignore the question of whether political actors have the incentive to do those things and only those things once we concede their role in the recovery. Once given the power to intervene, how can we be sure that power will not be expanded beyond what is believed to be necessary?

Furthermore, even if we were dealing with well-motivated political actors, we must ask whether they can know exactly what policy steps would be needed to produce a true recovery. This argument emerges out of the claim that a boom and bust cycle that looks like a 'macroeconomic' failure is ultimately a whole series of failures at the microeconomic level. In other words, the problem is not that macroeconomic aggregates such as unemployment or GDP need to be directly corrected. The problem is that they are a manifestation of the misallocation of resources among various markets resulting from the distortion in interest rates and other prices associated with the boom. Correcting them requires figuring out where resources should be given real costs and preferences now. Solving such problems is exactly what markets, and entrepreneurs who operate in them, are good at, so the overarching point is to set markets free to engage in this discovery process. Below I examine these points in more detail.

The history of various stimulus and recovery programmes clearly indicates that governments will not limit themselves to just those policies that mainstream economic theory, assuming that it is even correct on this point, suggests will help. Once given the power and intellectual rationale to intervene, politicians will gladly make that an excuse to propose and pass a whole variety of items, regardless of whether they fit the economist's model of a pump-priming stimulus.[5] The debate over the Obama Administration's stimulus package in the USA revealed just this sort of concern, as did the ensuing debate over his proposed budget in early 2009. In both cases, the claim was made that these expenditures were necessary for economic recovery, yet the significant resources pledged to health care, education and the environment have no known relationship to economic models of recovery. This is a precedent set by the Roosevelt Administration during the Great Depression, when even Keynes was moved to note that many of its proposals seemed more like 'reform than recovery'. When governments overreach in these ways, not only do they create additional costs (e. g. debt) that might offset any imagined gains, they can also slow the recovery of the private sector by adopting policies that pose long-term threats to the security of property or the possibility of market-earned profits. The result is what Robert Higgs (2006) has termed 'regime uncertainty' and has blamed for the length of the Great Depression.

[5] They will also tend to engage in expansionary fiscal policy even when it is not needed, leading to the cycle of spending, deficits and debt that has characterised the post-World War II Western market economies (see Buchanan and Wagner (2000 [1977])).

Even if the practical political problems could be addressed, the more fundamental point is that even theory should make us sceptical of government-driven solutions. Most macroeconomic policy recommendations are focused on aggregates such as consumption, investment and unemployment. This focus obscures the necessary adjustment processes as seen in the Austrian view, which have to do with the reallocation of resources among sectors at the microeconomic level. Debating policies that will 'create jobs' or increase net government spending to compensate for supposedly insufficient private sector activity is to not even ask the right questions.
Recall that the core of the Austrian story is how inflation drives interest rates artificially low leading to the misallocation of both capital and labour among the various sectors, with capital in particular being 'malinvested' in the earlier stages of long-term production processes. The Austrian theory is often wrongly termed an 'overinvestment' theory. There is some 'overinvestment' for a short period of time, but the real problem is that resources are being used in the wrong places. Traditional aggregates may not show any change in the total level of investment even as resources are misallocated between the earlier stages of production like research and development and later stages such as retail.

The downturn in economic activity we associate with the recession (or bust) is, on the Austrian view, the economy attempting to shed capital and labour from where it is no longer profitable. The fallible nature of humans and the imperfect, though still superior, discovery process of the market means that moving those resources to where they will be more productive will take time. Entrepreneurs at the earlier stages of production will idle capital and labour as their profitability shrinks and their counterparts at the later stages will now have to consider whether to purchase new capital or hire new labour. The prices of capital goods and the wages of labour might have to fall sufficiently to make such purchases profitable, and capital may require refitting and labour retraining so that they are a better fit for the post-bust economy.

This adjustment process requires the skilful judgment of entrepreneurs guided by market prices and profit and loss signals to determine where idled labour or capital can be profitably redeployed. Again, it is not a matter of there being too much or too little capital or labour, but whether specific capital goods or labour are suitable for a particular stage of production in a particular production process. Recognising that capital is not an undifferentiated aggregate, but specific, heterogeneous capital goods, means that it cannot be costlessly and instantly reallocated from the early stages to the later stages as mainstream theory often implies. The same is true of labour as well. Trying to substitute government spending for private investment suffers from the same problem as it overlooks both the shifts in specific capital and labour that recovery requires, as well as the comparative inefficiency of government versus private expenditures. Simply boosting aggregate measures of consumption and investment through any sort of government expenditure will not ensure that existing resources get reallocated away from sectors that were artificially stimulated by the boom to those sectors where consumers now wish to spend. Understanding this point, and therefore why government stimulus programmes will not work, requires a vision of capital and production that is less about statistical aggregates and more about microeconomic coordination processes.

Only those located in the context of the market have the knowledge and the feedback processes to make the decisions that will reallocate resources as quickly and effectively as possible. Even if we take out the inevitable politicisation of the process, government stimulus programmes will be much less effective at discovering where resources were misallocated and where they need to go. Again,

if the boom was the time the mistakes were made and the bust is the market's way of correcting them, then government interference with that subtle and complex correction process will just delay it. Only the decentralised decision-making and learning processes of the market can accomplish the millions of corrections that have to take place in myriad individual microeconomic markets.

So, is there any sort of positive programme for recovery to offer, or is this just a counsel of despair or 'doing nothing'? Firstly, saying that government should do nothing is hardly the same as saying that people should do nothing. Recovery depends upon active and creative entrepreneurship on the part of millions of economic actors. It is they who should be 'doing something', and for the entrepreneur-driven recovery process to happen quickly and effectively, policymakers must refrain from interfering with that process and attempt to create a stable and predictable environment in which those entrepreneurs can operate. Policymakers should take their first task as minimising Higgsian regime uncertainty and thereby facilitating the countless individual adjustments that constitute recovery. Their second task should be radical supply side deregulation in labour and product markets to facilitate the movement of factors of production to different uses.

The Austrian perspective suggests that the root of the problem is not bad 'policies' alone, but also bad institutions. Generating a sustainable recovery requires that we address the underlying institutional causes of the recession, namely the ability of central banks to expand credit at their discretion and thereby initiate the boom and inevitable bust. One proposal to address this problem would be to end the privileges associated with central banks and allow privately-owned banks to issue currency competitively and enable them to develop inter-bank institutions such as private clearing houses like those of the 19th century. Such clearing houses would be able to take on many of the tasks of central banks, only more effectively, as they did before they were rendered unnecessary by the creation of central banks.[6] A move to a 'free banking' system would stop the credit expansions that generate the boom and bust cycle and the accompanying recessions. Ending central banking would also make it harder for governments to borrow themselves into large debts, as it would remove the possibility of using the central bank to buy up debt the public does not want. As the stimulus plans adopted by so many Western countries, along with their ongoing unsustainable welfare state commitments, continue to drive up the burden of government debt across the world, the temptation to use inflation to buy up that debt will continue to grow. Unfortunately, should governments succumb to that temptation, it will only set in motion yet another chain of events that will create another, and possibly worse, boom and bust cycle. Separating money production from the state is the key institutional change necessary to both speed up the current recovery and to prevent future, and much worse, recessions.

[6] See White (1996) and Selgin (1988) on the argument for 'free banking'.

# Conclusion

The Great Recession was not a failure of free markets. Rather it was a classic example of the undesirable unintended consequences of government intervention, both through expansionary monetary policy and misguided attempts to bolster the housing market in the USA. This combination produced an unsustainable boom in the years following 9/11, with the focus of that boom being a policy-induced asset bubble in housing and the resulting collection of financial instruments built on that bubble. Because the boom involved the misallocation of resources due to false interest rate signals, it is proper to characterise the boom as the making of the mistakes and the inevitable bust as their correction. Furthermore, the only way to correct that misallocation is to let entrepreneurs guided by market prices, profits and losses figure out where resources now need to go. Government spending programmes are both too blunt and too politicised an instrument to do the job. In the long run, the way to prevent the damage of the boom and bust cycle is to cut the problem off at the root by reform of the monetary system that will end the privileges accorded to central banks. Getting government out of banking is the best way to get the banks out of government and to end the disastrous boom and bust cycles that have characterised the last century and a half.

# References

Beckworth, D. and G. Selgin (2010) ‘Where the Fed Goes Wrong: The “Productivity Gap” and Monetary Policy’, manuscript, 20 April, http://econfaculty.gmu.edu/pboettke/workshop/Spring2010/Beckworth2.pdf.

Buchanan, J. M. and R. E. Wagner (2000 [1977]) *Democracy in Deficit: The Political Legacy of Lord Keynes,* Indianapolis: Liberty Fund.

Garrison, R. (2001) *Time and Money: The Macroeconomics of Capital Structure,* New York: Routledge.

Hayek, F. A. (1966 [1933]) *Monetary Theory and the Trade Cycle,* New York: Augustus M. Kelley.

Hayek, F. A. (1967 [1935]) *Prices and Production*, second revised edition, New York: Augustus M. Kelley.

Hayek, F. A. (1975 [1939]) *Profits, Interest, and Investment,* Clifton, NJ: Augustus M. Kelley.

Higgs, R. (2006) ‘Regime Uncertainty: Why the Great Depression Lasted So Long and Why Prosperity Resumed after the War’ in *Depression, War, and Cold War: Studies in Political Economy,* Oakland, CA: The Independent Institute.

Horwitz, S. (2000) *Microfoundations and Macroeconomics:* An Austrian Perspective, New York: Routledge.

Horwitz, S. (2009) ‘The Microeconomic Foundation of Macroeconomic Disorder: an Austrian Perspective on the Great Recession of 2008’ in S. Kates (ed.) *Macroeconomic Theory and its Failings: Alternative Perspectives on the Global Financial Crisis,* Cheltenham: Edward Elgar, pp. 96-111.

Horwitz, S. and W. Luther (2011) ‘The Great Recession and its Aftermath from a Monetary Equilibrium Theory Perspective’ in S. Kates (ed.) *The Global Financial Crisis: What Have We Learnt?*, Aldershot: Edward Elgar, pp. 75-92.

Koppl, R. (2001) *Big Players and the Economic Theory of Expectations*, New York: Palgrave Macmillan.

Mises, L. v. (1966) *Human Action: A Treatise on Economics*, Chicago: Henry Regnery.

Selgin, G. (1988) *The Theory of Free Banking: Money Supply Under Competitive Note Issue*, Totowa, N. J.: Rowman and Littlefield.

Taylor, J. B. (2009) *Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis*, Stanford, California: Hoover Institution.

White, L. (1996) *Free Banking in Britain*, 2nd edition, New York: Routledge.

**Institute of Economic Affairs**
**2 Lord North Street**
**London**
**SW1P 3LB**

**www.iea.org.uk**