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| Library of Economics and Liberty masthead logo | ECONTALK PERMANENT LINK | FEBRUARY 1, 2010Printable format for  <http://www.econtalk.org/archives/2010/02/larry_white_on.html>FAQ: Print Hints**Larry White on Hayek and Money**EconTalk Episode with Lawrence WhiteHosted by [Russ Roberts](http://www.econlib.org/library/About.html#roberts) |

[**Larry White**](http://economics.gmu.edu/faculty/lwhite.html) of George Mason University talks with EconTalk host [**Russ Roberts**](http://www.econlib.org/library/About.html#roberts) about Hayek's ideas on the business cycle and money. White lays out Hayek's view of business cycles and the role of monetary policy in creating a boom and bust cycle. The conversation also explores the historical context of Hayek's work on business cycle theory--the onset of the Great Depression and the intellectual battle with Keynes and his work. In the second half of the podcast, White turns to alternative ways to provide money, in particular, the possibility of private currency and free banking explored by Hayek late in his career. White then describes his own research on free banking and in particular, the more than a century-long experience Scotland had with free banking. The podcast concludes with the economics rap "Fear the Boom and Bust," recently created by John Papola and Russ Roberts. The song itself can be downloaded at EconStories.tv where viewers can also watch the video, read the lyrics, and find related resources on the web for Keynes and Hayek.

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| **About this week's guest:*** [**Larry White's Home page**](http://economics.gmu.edu/faculty/lwhite.html)
* [**EconStories.tv**](http://econstories.tv/). Home of the rap video "Fear the Boom and Bust," John Papola and Russ Roberts. Video and stereo audio versions, lyrics, and links.

**About ideas and people mentioned in this podcast:****Books:*** + [***The Denationalisation of Money***](http://www.iea.org.uk/files/upld-book431pdf?.pdf), by [**F. A. Hayek**](http://www.econlib.org/library/Enc/bios/Hayek.html). Pdf file, Institute of Economic Affairs.
	+ [***The Rationale of Central Banking and the Free Banking Alternative,***](http://www.econlib.org/library/LFBooks/SmithV/smvRCB.html) by Vera Smith. On Econlib.
	+ [***Economics as a Coordination Problem: The Contributions of Friedrich A. Hayek,***](http://www.econlib.org/library/NPDBooks/ODriscoll/odrCP.html) by Gerald P. O'Driscoll, Jr. Particularly [**Chapter 3: The Monetary Theory.**](http://www.econlib.org/library/NPDBooks/ODriscoll/odrCP3.html#Chapter%203) On Econlib.

**Articles:*** + [**Nobel Prize Lecture**](http://nobelprize.org/nobel_prizes/economics/laureates/2004/prescott-lecture.html) by [**Edward Prescott**](http://www.econlib.org/library/Enc/bios/Prescott.html).
	+ [**"Why Private Banks and Not Central Banks Should Issue Currency, Especially in Less Developed Countries"**](http://www.econlib.org/library/Features/feature3.html), by Lawrence H. White and George Selgin. April 19, 2000. On Econlib.
	+ [**Business Cycles**](http://www.econlib.org/library/Enc/BusinessCycles.html), by Christina Romer. *Concise Encyclopedia of Economics.*
	+ [**Competing Money Supplies**](http://www.econlib.org/library/Enc/CompetingMoneySupplies.html), by Lawrence H. White. *Concise Encyclopedia of Economics.*
	+ [**Present Value**](http://www.econlib.org/library/Enc/PresentValue.html), by David R. Henderson. *Concise Encyclopedia of Economics.*
	+ [**Inflation**](http://www.econlib.org/library/Enc/Inflation.html), by Lawrence H. White. *Concise Encyclopedia of Economics.*
	+ [**Austrian School of Economics**](http://www.econlib.org/library/Enc/AustrianSchoolofEconomics.html), by Peter J. Boettke. *Concise Encyclopedia of Economics.*
	+ [**Money Supply**](http://www.econlib.org/library/Enc/MoneySupply.html), by Anna Schwartz. *Concise Encyclopedia of Economics.*
	+ [**Fiscal Policy**](http://www.econlib.org/library/Enc/FiscalPolicy.html), by David N. Weil. *Concise Encyclopedia of Economics.*
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	+ [**Knut Wicksell**](http://www.econlib.org/library/Enc/bios/Wicksell.html). Biography. *Concise Encyclopedia of Economics.*
	+ [**Friedrich A. Hayek**](http://www.econlib.org/library/Enc/bios/Hayek.html). Biography. *Concise Encyclopedia of Economics.*
	+ [**Eugen von Bohm-Bawerk**](http://www.econlib.org/library/Enc/bios/BohmBawerk.html). Biography. Roundabout production. *Concise Encyclopedia of Economics.*
	+ [**Joseph Schumpeter**](http://www.econlib.org/library/Enc/bios/Schumpeter.html). Biography. *Concise Encyclopedia of Economics.*
	+ [**John Maynard Keynes**](http://www.econlib.org/library/Enc/bios/Keynes.html). Biography. *Concise Encyclopedia of Economics.*
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	+ [**Milton Friedman**](http://www.econlib.org/library/Enc/bios/Friedman.html). Biography. *Concise Encyclopedia of Economics.*
	+ [**Irving Fisher**](http://www.econlib.org/library/Enc/bios/Fisher.html). Biography. *Concise Encyclopedia of Economics.*

**Web Pages:*** + [**Economists' Rap Battle Gains Cred From Ke$ha's Nod**](http://ww.npr.org/templates/transcript/transcript.php?storyId=122944753). NPR transcript, interview with John Papola, Russ Roberts, Kesha. [**Listen to the NPR podcast.**](http://www.npr.org/templates/player/mediaPlayer.html?action=1&t=1&islist=false&id=122944753&m=122956268)

**Podcasts and Blogs:*** + [**John Taylor on the Financial Crisis**](http://www.econtalk.org/archives/2009/07/john_taylor_on_1.html). EconTalk podcast.
	+ [**Belongia on the Fed**](http://www.econtalk.org/archives/2010/01/belongia_on_the.html). EconTalk podcast.
	+ [**Sumner on Monetary Policy**](http://www.econtalk.org/archives/2009/11/sumner_on_monet.html). EconTalk podcast.
	+ [**Calomiris on the Financial Crisis**](http://www.econtalk.org/archives/2009/10/calomiris_on_th.html). EconTalk podcast.
	+ [**Boettke on the Austrian Perspective on Business Cycles and Monetary Theory**](http://www.econtalk.org/archives/2009/01/boettke_on_the.html). EconTalk podcast.
	+ [**Selgin on Free Banking**](http://www.econtalk.org/archives/2008/11/selgin_on_free.html). EconTalk podcast.
	+ [**Gene Epstein on Gold, the Fed, and Money**](http://www.econtalk.org/archives/2008/06/gene_epstein_on.html). EconTalk podcast.
	+ [**Reinhart on Financial Crisis**](http://www.econtalk.org/archives/2009/11/reinhart_on_fin.html). EconTalk podcast.
	+ [**Higgs on the Great Depression**](http://www.econtalk.org/archives/2008/12/higgs_on_the_gr.html). EconTalk podcast.
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**Highlights**

| **Time** | **Podcast Highlights**HIDE HIGHLIGHTS |
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| 0:36 | Intro. [Recording date: January 27, 2010.] Friedrich A. Hayek's view of the business cycle and money. Rap song, John Papola and Russ Roberts, at end of interview; video at EconStories.tv. Business cycle: What did Hayek see as the cause of the business, the booms and busts? Two scenarios. One: Central Bank independently decided to cheapen credit, expand the supply of loanable funds--Wicksellian phrase--ignite and investment boom. Second scenario more subtle: investors become more optimistic, new technology they want to invest in; come to banks and want to borrow more; instead of banks letting that drive the interest rate up, the Central Bank becomes involved by injecting enough credit to keep the interest rate from rising. So, first theory is the supply of loanable funds shifts first; second is that demand shifts first, but then the Central Bank shifts the supply to accommodate the demand. As the "real bills doctrine" used to put it: to supply the needs of trade. In either case, bad idea; drives the market interest rate below the equilibrium or natural rate and creates a disequilibrium between the plans of savers and investors. Investors are trying to invest more resources than are really available in the economy; consumers don't want to delay that much consumption. First scenario: Fed mistakenly or because of political pressure artificially lowers interest rates. That does what in the real economy that causes a problem? Think of investors having lots of investment plans on their shelf with different rates of return; interest rate serves as a rationing device, benchmark that an investment plan has to clear to make it worth it. As the interest rate goes down, more and more investment plans begin to look like they'll pay back enough to cover the cost. Plans come off the shelf, which increases the quantity of money. In particular, Hayek emphasizes: it's the most interest-sensitive plans that are going to take off in a low-interest environment; and those are the ones that involve a lot of time between the investment and the rewards being reaped--basic principle of finance. You discount your cash flows back to the present. If you can borrow just a little more cheaply, long term investment projects become more attractive. |
| 4:42 | Continue the story: Some projects get undertaken. Sounds good! More investment! What's wrong with that? There are only so many resources in the economy--only so many workers, equipment, raw materials; they get drawn away from more sustainable investment projects into these other projects that aren't appropriate for the state of demand in the economy, the time-preferences of consumers. Economy invests in roundabout production, early stages of long-term projects; other parts start to languish; shorter projects become starved for resources. Misallocation; which would mean that the pie is not as big as it could get. But that's not the end of the story. Projects that need a long time to come to fruition need continual investments; you don't usually investments at once and wait; you have to keep tending the tree. That's where the problem comes. As resources are expended to keep these projects going, they start to bid up the prices of labor, materials, and machines; other businesses find their costs of production going up. Input prices going up; not enough to go around. At some point it becomes clear that there aren't enough savings to bring all these projects to fruition and some have to be terminated--they aren't going to make a profit. Will lead to unemployment in those industries that made the wrong investment. In the last boom and bust, it was the housing industry that took off. Characteristic of the Hayekian process is where you see half-finished investment projects being abandoned because they will not be profitable. Half-built condominium projects on the outskirts of Las Vegas. But those were stopped because the interest rate changed; the funding changed. In the current situation--John Taylor's story--the artificially lower interest rates of the 2002-2004 period encouraged lots of borrowing and construction; but when raised by Greenspan in 2004-2005 they became unprofitable. In the Hayekian story, does it require the rise in interest rates? That's the usual symptom of their being more investment than savings. In the short run or intermediate run if the Federal Reserve is controlling interest rates, it comes through the news as the Central Bank decided that it needs to raise interest rates. They are bowing to the inevitable; scarcity of resources is pushing interest rates back up to equilibrium. |
| 9:35 | Wouldn't this also happen in any industry where there is innovation? Take the Fed out of it for the moment and talk about creative destruction--Schumpeter's term--the idea that innovation and new ideas come along, new business comes along; draws resources away from other areas. Price system tries to soften the transition; can't do it perfectly, imperfect information. As a new sector springs up--automotive industry at end of 19th century, internet industry at the end of the 20th century--people are drawn to these new opportunities; some will turn out to be failures. Not artificially induced by an artificially low interest rate. Amazon was unprofitable for a long time; profitable now. Took all kinds of resources that made it hard for other businesses to thrive. That's a healthy kind of growth; test is whether projects do become profitable. If because of new technology, economy has a new set of investment projects that promise higher payoffs in the future, people will be willing to save to provide investment for those projects. New demand for investable resources bids up the interest rate if the Central Bank allows it to happen. Hayek referred to this as the interest rate brake, preventing the economy from overinvesting. To bid the resources away from the current users, businesses have to pay a little more. Healthy, brings about economic growth. Problem comes in second scenario; if Central Bank decides interest rate ought not to rise and pumps in enough credit so that you get the new investments and the old investments, then you get the danger. Some will be profitable like amazon, but pet-dot-com didn't make it. Very often, an overinvestment or malinvestment boom piggybacks on an overinvestment boom. It's just allowed to go too far because the Central Bank is over-accommodating. What influence did the Austrian and Hayek theories have on real business cycle theory, the time-to-build work, Prescott, and others? Empirical puzzle for monetary malinvestment theories: Thought experiment: Central Bank changes policy, makes the interest rate low. We should see a burst of new investment starts. Hard thing to explain is why the change in investment persists even after the change becomes evident to everybody. That's what the time-to-build model attempts to explain: you don't just invest all at once; you have to make continuous investments. Mike Montgomery, U. of Maine, has written papers trying to apply the modeling technique of Kydland and Prescott to show that there's more mileage in the Austrian approach. Some have disrespected--not sure of verb looking for. Sometimes hear references to distress borrowing. |
| 16:31 | Role of expectations. When the Federal Reserve plays with the current interest rate, it goes down if we are talking about the current crisis, 2002-2004; low for an unusually long time, negative in real terms for a couple of years; most people expect those rates to go back up at some point. If I'm planning a long-term investment, say, with this time-to-build, delayed, ongoing investment--not so much building a house, but an amazon--will have to build warehouses, will have to advertise--will be pumping money in continually over a fairly long period of time. Why would I respond to low interest rates if I know they are only temporarily low--forget rational expectations--if I just reasonably expect that that's not going to persist? Wouldn't it be surprising if short-run changes in interest rates generate these long-term projects? Good question; has to be answered to make sense of Hayek's theory. If everybody had perfect expectations, perfect foresight about the path of interest rates, you wouldn't see this cycle. It doesn't require that everybody guess wrong. It just requires that too many people guess wrong about the path of interest rates, in order to get enough malinvestment to cause a problem. Piggybacked on sustainable investments. People are convinced now that it's a new era--*This Time is Different,* by Rogoff and Reinhart. Reinhart podcast. Sometimes Fed has encouraged this: Greenspan talked about the "new economy" in the midst of the dotcom boom. Supposed to be permanent, ever-higher productivity growth. Can get the problem. There's no doubt there's a wide distribution of savviness; uncertainty. Differences of opinion about how soon and how much; people want to make their money now and get out at the right time; uncertainty about how long the money is going to stay cheap. Political pressure to keep it cheap. Very, very low interest rates now; but artificially low; Fed trying to keep rates low for home-buying. Big spread now between short-term and long-term interest rates. Would avoid getting caught if you locked in for the long-term, but tempting to borrow at the low short-term rate and roll it over--and that's when people get caught out. U.S. Government doing that now. When U.S. Government borrows short-term, they have an incentive to promote inflation; can refinance their debt. |
| 20:54 | Economic history. Hayek's most important book on this subject--*Prices and Production*, 1931. Did he have a story to tell for what started the Great Depression? That was his story. His story was that the Federal Reserve and the Bank of England had injected credit during the 1920s and built up a credit bubble. Done it during a genuine period of high growth in the economy in order to keep the price level from falling--they were stabilizationists, inspired by keeping price level stable. Hayek argued said in 1933 that for several years he had been arguing against the stabilizationists. In an environment of growing output, it requires a continual injection of money to keep the price level from falling; and that injection of credit distorts the interest, and that causes the problem. Hayek criticized earlier economists who said that if the price level is flat, everything must be fine--that's not the indicator you want to look at. Argued that you want to look at relative prices, early vs. late stage investment, structure of production. Explanation for why the boom of 1920s couldn't last. Attracted a lot of followers. Something went wrong; by the 1940s, he was out of favor as a macroeconomist. Austrian business cycle theory neglected, almost forgotten by the economics profession. Why? Another guy came along--Keynes. Hayek was not the only guy troubled by Keynes's ascent--Schumpeter also was very resentful. Both are remembered fondly by other economists; but their work on microeconomics is well-respected, but it's their macro stuff that got put on the shelf. What happened? Events kept moving forward. Hayek had, arguably, a good explanation for the downturn. He didn't have such a good explanation for why the economy continued to deteriorate after 1931--continued to go down and stayed down for so long. He actually had a prescription for what to do about it. In *Prices and Production*--which we did at the time--he said that the Central Bank should try to stabilize the money stream--nominal GDP, or MV, money times the number of times it's turning over, V, velocity of money. If people are hoarding, inject more money. Also Milton Friedman's advice. But Hayek didn't say that based on his own advice, and later apologized for it: had fond wish that a little deflation would help break the rigidity of prices and wages and restore a more flexibly functioning economy--pipe dream. Did not call for Central Banks to do what his own theory called for--keep spending to continue from encouraging downward spiral. Other Austrians offered what advice for what they called a "secondary deflation." Kind of overkill, having economy going through this deflationary cycle. Hayek should have spoken out more against it; didn't do so. Viewed as having nothing useful to say about how to stop the cycle, even if he had been right about how it started. In that kind of environment, as Friedman has said, Hayek's picture of events was regarded as very gloomy--nothing we can do, had to let the economy purge the problems out of the system in the most painful way possible. When Keynes came along, it was regarded as a message of hope. Here's something we can do. We don't have to just sit by and linger in the depression; something active we can do. Same hopeful message a year ago with the stimulus package; hopeful message keeps selling. Idea that fiscal policy--playing around with government spending and taxes--has enjoyed a comeback. Thought it was dead; thought evidence showed it was too little too late or doesn't have any effect because offset by private spending. Reason may be view that the Fed is out of bullets--interest rates can't go any lower so they can't do anything. Think that's wrong. Some economists have rediscovered idea that monetary policy still is the thing that's ruling the behavior of the economy--if we'd prevented the shrinkage in nominal GDP, the recession would have been milder. Scott Sumner argument; podcast. Difficult to know whether that's right. Can't eliminate recessions that way. There were real malinvestments. When those are written down, real income has to decline. Resources are unemployed temporarily till they can find more sustainable uses. But you don't want to exacerbate it by making it hard for people to repay their debts because, say, nominal income is shrinking. |
| 29:06 | Money; what the Fed has done wrong. What should the Fed to get it right to avoid these booms and busts? What did Hayek say about what the Fed should be doing? Hayek had talked about the issue on various levels. When he took for granted that you should have a Central Bank issuing fiat money and asked what's the most neutral monetary policy they can pursue, what will do the least damage to the economy, he was always a strong opponent of inflation, against the idea that you could stimulate the economy in any useful way by cheap money. But he suggested early on trying to stabilize the spending flow in the economy--nominal GDP. In *The Constitution of Liberty* he later said that maybe a shorthand way of doing that would be to stabilize an index of wholesale prices. Still didn't want to stabilize consumer prices because of the problem he pointed to in the 1920s--you are injecting more credit when productivity is high, and that can cause a credit bubble. But instead focus on input prices. As the 1970s went on, and inflation got out of hand, he started thinking more fundamentally about the institutional arrangement: not what the Fed should do, but is there some institutional arrangement, some regime change, that would give us better performance than we are getting from Central Banks. Famously published a pamphlet in 1976 called *Choice and Currency,* where he said to protect ourselves against inflation, people ought to be free to use whatever currency in the world they find more stable. That would put a damper on the inflationary proclivities of any one Central Bank. Then he pushed it a little further and said why don't we let private firms into this competition; published a monograph: *The Denationalization of Money*--available on the web at IEA at no charge. Argues against the presumption that government has to provide money and imagines what would happen if private firms were providing money, and fiat-type money: money that is not based on gold or silver but based on the promises of these private banks that they would keep the value stable; might be more reliable than central banks have been. Easier to hold private firms to their promises than to hold central banks to their promises. Historical context: for those of us in our fifties living in the United States, the worst inflation of our lifetimes was in the 1970s, when inflation reached 13.3% in 1979. Scared a lot of people. In the last year or two, some question as to whether we've had deflation, if it was mild; but for somebody like Hayek, they had seen hyperinflation, not just in Zimbabwe, which we read about in the paper, but in many of the nations of Europe. In Germany, in the aftermath of WWI, hyperinflation led to political consequences, partly leading to the rise of Hitler. Fear of inflation must have been very different for that generation. Hayek in his correspondence with Keynes was very uneasy about the threat of inflation in the 1940s. Vigilant; this creature had to be contained. Under the institution of the gold standard, which prevailed for the early part of Hayek's life, there is no tendency toward a rising price level; some periods of mild deflation, even periods when output tends to grow a little faster than the price of gold. Anything about 0 in the price level is cause for concern. Hayek: need to look behind the scenes. Concerned about the consumer price index but also what was behind it, excess growth in Central Bank credit. In the 1970s, these inflation and consumer price index inflation in Great Britain was in the 20% range--much higher than the United States, very alarming. |
| 35:37 | Turn to *The Denationalization of Money*. If Hayek was proposing a private money supply, what would be the implications for his story of the interest rate as coordinating the plans of savers and investors? What would be the interest rate path, path of inflation, under a denationalized money in Hayek's view? Written about this: in *The Denationalization of Money* Hayek seems to switch toward favoring stability in the consumer price index, contrary to what he believed his entire career. It was his explanation for the crash of 1929. But in *The Denationalization of Money* he says private money issuers would most appeal to the public if they promised stable prices. Has a little footnote: Yes, yes, I'm among those who pointed out this could be a problem, but I no longer think it's a problem of much practical relevance. Trouble making sense of that. Think what he's saying is that when you are talking about Central Banks creating problems of 25% inflation, that's a much bigger practical problem than the malinvestment caused by trying to create a stable price level. Go back to 1931-1932 for a minute: talking about why Hayek's ideas fell out of favor. Gloomy story; waiting it out takes a long time. Others have argued that that long time wasn't Hayek's fault: there was regime uncertainty. Bob Higgs has argued that--Roosevelt frantically intervening in a lot of ways in the price system and the rules of the game, so private investment takes horrible tumble in the 1930s; could be for other reasons as well. Add in all these stories: Higgs: regime uncertainty; Friedman: money supply collapsing. Not just uncertainty about Roosevelt was going to do, but what Roosevelt actually did in the National Recovery Act and the Agricultural Adjustment Act. Organized agriculture to restrict output in the name of raising prices, in the name of restoring profits, and thereby prosperity. Non sequitur there: you can make one industry more profitable by cartelizing it and increasing its profits, but you can't do that for everybody because it only works by restricting output. If everybody restricts output, it's even worse. Industries restricting output are not going to be hiring more workers--they will be cutting back on all those things. Strange idea that still has some life of its own. |
| 40:09 | Piece of Keynes that is fruitfully tied into the story of Hayek: The role of animal spirits, psychology, fear of the future, uncertainty--reference in rap video we are about to hear. Believe Keynes was wrong that that was what causes business cycles, seems there is a part of what makes it difficult to cope with them. For example, equation of exchange, Irving Fisher: MV=PT. Amount of money times the number of times it turns over--that's total spending--equals the amount of economic activity time prices. People are holding onto money because they are anxious. So now people are a little more cautious. That's hard to measure. No handle on that; don't know how severe it is. Offsetting that with M is going to be an inherently difficult thing to do. That's why Milton Friedman said Central Banks have done a bad job of it and shouldn't even try. Should just target M, let it grow at a slow steady rate; fine as long as velocity is relatively stable. One argument would be that V is stable so long as the government doesn't mess around with M, so if M is stable, then V will be responding to whatever people are responding to normally, so pretty stable. Once the government starts messing with M, then V will be relatively unstable. Keynes: could stuck in 1933. Could not have a good answer, either as Hayek or Keynes. The one thing the government needs to do now is create confidence about the future; and that's the one thing that economists, psychologists, and government policy makers know very little about. New plan every week; which tends to undermine. Two problems: One is that people are trying to hang onto their money and not spend it because they don't know what's coming. More generally, investors are going to put off launching new projects until it becomes clear what the environment's going to be. Creating uncertainty in the tax environment just makes it worse. Once the Central Bank and the Treasury and whoever else has made the policy that has dug us into a deep hole, it's not easy to climb out. No magic bullet for doing that. Need to put stable policies in place to allow people to start planning for the future again. Argument for doing nothing; risky politically. Argument for the rule of law. But we have to do something--only if it makes it better--which seems to be the next part of that sentence. |
| 45:38 | White's ideas, arguments on money and the institutions that might lead to a better world. What do you think we ought to be doing with the money supply, and what is the role of the Fed, if any? What do you advocate? First best idea: not imagining will happen any time soon--monetary systems based on a gold or silver system in which banks compete to issue currency. Traditionally known as a free banking system. No Central Bank. All kinds of money supplied by private institutions. The private institutions discipline each other. Any bank that issues more money than its customers want to hold will find its money returning to it for redemption. It will be losing reserves to the other banks. Tradition based historically on gold and silver that the banks don't issue. Acts as a constraint; constraint made by banking system as a whole. Redemption: Would the redemption process be mandated by law or would it emerge through the competitive process? Part of the contract that banks have with their customers, so part of the competitive process. We have something like that today: your checking account is redeemable in Federal Reserve Notes. Your Federal Reserve Notes are the basic money. You can go to your bank and empty out your bank account. That's your deal with the bank. You wouldn't open a bank account at a bank that didn't promise to let you do that whenever you wanted. In the old days, people did that with bank accounts but the basic money was gold or silver coins, which banks had to promise to deliver whenever people wanted it. Mostly people open accounts so they can pay each other, so they can write checks; so banks have to make good at the clearing house on checks written to people at other banks. Checks come back: we just credited our customer with $50 because your customer said he needed to get it from you. That's the clearinghouse. Banks are always transferring reserves to each other; that's where this constraint is immediately felt. What would be the amount of the reserves that a bank would hold to engender my confidence in this world? The bank has to figure out what reserves it would have to hold in order to meet the redemption demands it has to meet at the end of the business day--at the clearing house. Empirically, banks have to figure this out. It's a practical problem. That's what bankers are good at. Historically banks, in the early days, when reserves were hard to replenish--it was hard to get a shipment of gold from somewhere else--banks would hold 30-40% reserves. As railroads were built, as banks became more sophisticated about managing their assets, gold and silver reserves sometimes went down to 2%. Those weren't the only resources banks had. They had very liquid assets any bank could sell. Any particular bank would have commercial paper or government bonds that it could sell very quickly to replenish its reserves. But banks were very vigilant about meeting all the redemption demands that came to them. But in those days--what period of time are we talking about? Most written about: Scotland, between 1720 and 1845. Very long time, trial. Canada had a fairly free banking system up to the Bank of Canada Act in 1935. Lots of historical experience with these kinds of systems. Kevin Dowd book collected experience in those times. But in those times, there were still runs on banks. What about the stability of the economy as a whole? Competition proponents confronted with "Well, before the Fed, established in 1914, we had all kinds of recessions, depressions, bank runs, problems, so even if you put the current crisis at the Fed's doorstep, and even the 1933, 1929 Great Depression--it wasn't all paradise before that. Free banking more or less stable than the current regime? Bank runs and financial panics were a problem in the United States in the late 19th century. Taken as the number 1 rationale for Central Banking and when Central Banking didn't solve the problem with deposit insurance in the 1930s. If you look around the world, don't just look at the United States, you find that bank runs and financial panics are actually pretty rare. Don't seem to be an inevitable consequence of having a fractional reserve banking system. Much more common in the United States than in Canada, where there are no financial panics; much more common in England than in Scotland. Begin to think: if you want a stable banking system, maybe it has to do with the way banks are regulated. The instability of banking in the United States is due to the peculiar regulations on U.S. banks. In particular, U.S. banks were not allowed to branch out; never across state lines and often not within states. That meant the banks were undercapitalized, under-diversified. Secondly, restrictions on banks' ability to meet shifts in the public's desire to hold currency rather than deposits. Known as the inelasticity of the currency. There was a ceiling on the amount of bank notes a bank could issue, set by the National Banking Acts. Panics have a history. They typically begin in the fall. What happens is farmers come to the bank and say "I need to pay my farm workers." They don't have bank accounts, so can't write checks. Banks would say "We're not allowed to issue more bank notes." Farmer says: but you still have to give me currency, have to let me redeem my deposits, so I'll take silver coins, or I'll take greenbacks--money issued by the government that served as reserves. A problem the banks could have solved by changing the form of their liabilities between deposits and notes turns into a reserve drain. The country banks start pulling reserves out of the cities; the cities then start pulling money out of New York, and then we've got a panic. In countries that didn't have these restrictions on banks, you didn't find those events. Created by our regulation; not a natural weakness. |
| 54:09 | Why do you think the Fed was created? Fed was created to solve these panic problems. But there was another way to do it. There were people in the United States who said: Hey, look at Canada--they don't have these problems. Why don't we look at Canada? That kind of reform was blocked by the small banking lobby. They said: Canada has nationwide branching of banks. If we allow that, my neighborhood is going to be invaded by banks that are better run than mine; I can't allow that. Of course, small banking lobby is hard to remember. Very powerful. It wasn't until 1995 that banks got to branch across state lines in the United States. In some states you couldn't branch within the state. Unit banking. Russ: graduate student in Chicago [1970s]: you were allowed to have two drive-up windows in Illinois within a certain radius of the main office. Illinoise, strange, anticompetitive. Texas also strange: two-thirds of the banks failed when the because they were not diversified outside Texas. Almost all their loans were oil-related industry or real estate. Part of the political problem: seeming unfairness of losing all your money in one bank. You put all your money in one basket; there's a run on that bank, maybe rare, but effect on you. Most of the time in American history, we let bad decisions yield bad consequences. You make a lousy car, your car company goes out of business. You may a lousy product, you lose your money. If you run your bank badly, normally we'd say you go out of business. But if it imposes a very large cost on a small group of identifiable individuals, the political demand for the Federal Deposit Insurance Corporation (FDIC) must have been part of the story as to why people wanted to get the government into the banking business. Surprising thing is how long it took to get Federal Deposit Insurances; and when it passed, it was by the thinnest of margins. Franklin Roosevelt (FDR) was actually against it--Governor of NY. Almost inevitably went broke, paying out too much money to failed banks. Not popular idea at the Federal level. But the FDIC has the backing of the Federal Reserve, and they can always print money. FDR letter to the Editor he wrote: FDIC, which he opposed, was a moral hazard. Deposits always guaranteed, so it will encourage bad investments. Argument he made and also made by large banks. Proponents of deposit insurance at the time were small banks: people think we are weak, but if we can look just as solid as the larger banks people will stop withdrawing their money from us and putting it into larger banks. Even the playing field. Triumph for the small bank lobby. If a problem arises from bank runs, there is a way for banks to anticipate and build in a a circuit-breaker into their contracts: Notice of withdrawal clause. Trust banks traditionally had this before Federal deposit insurance. What it said was: in the event we need to, you need to give us 60 or 90 days' notice before you withdraw your money. You wouldn't want the bank to invoke that on you; but you would if the alternative was everybody else in the bank empties it before you get there. You'd like them to invoke that clause on the other depositors. The 90 days gives the bank time to sell off some of its other assets, avoiding firesale losses. Historical research on bank runs indicates that the reason people run is run is not fear of people running. People typically ran when the bank was already insolvent. Healthy purpose of closing the bank before the bank lost even more money. True, the losses were unevenly distributed, depending on whether you got on the front of the line or the back of the line. In a way, that provides a useful incentive mechanism: monitor your bank and don't rely on other people to monitor it for you. |
| 1:00:29 | Just have the government monitor it. That way I can sleep at night. Unless the government monitoring system goes bad. Another contractual mechanism: extended liability for bank shareholders. In the Scottish free banking era, bank shareholders had unlimited liability--if the bank assets declined in value or had bad loans, a letter would go out to the shareholders saying you have to chip in. Banks did fail, but the depositors didn't end up losing any money. It was the shareholders. Scotland: great poetry, great fly-fishing, great single malt scotch, great model for how we ought to organize banking. Adam Smith; ironically now on Britain's 20-pound note. Competitive and innovative, training ground in the 19th century; spread throughout world; modern ideas on banking. Accidentally left haggis off the list of great Scottish contributions; swear on it, swear at it. Free banking politically unlike to be a starter right now. Never been a time in recent American history when people have been more hostile to a Central Bank. Remarkable. Ben Bernanke. Fix the Fed: get the right person in the job. Neglects the incentives the person faces in the job; changed for Bernanke from when he was an academic to when he was a Central Banker. Not going to talk about legislation. But pick the right person or tinker with the institution? Belongia podcast. Any politically viable small step we could make toward a free banking world without having to do it in one swoop? Open the door? Hard sell. Ben Bernanke's survival turns on the fact that he has critics on both the left and the right. Not going to agree on who should replace him; he will emerge as the compromise. Some incremental steps we can take; but don't expect free banking any time soon. Strong version of placing a binding rule on the Fed, path of particular economic policy. Haven't seen much willingness. Strong form--eliminate the Central Bank--unlike. But just as the U.S. postal system has become less relevant as private firms have been allowed to enter the market--overnight letters by UPS or FEDEx do not constitute an entrenchment on the U.S. monopoly on mail--less and less of a problem for consumers. Innovation in payments mechanisms will allow people easier access to other forms of money; might help constrain Central Banks. In the 1990s, Randy Crosner, competition between Central Banks losing market share and competition making them behave more responsibly. Offshore bank accounts, precious metals, more options; if the dollar becomes more iffy. Currently tax disadvantages to putting your money in precious metals--have to pay capital gains taxes if your gold holds its value while the dollar drops. You get taxed on that, even if you haven't made any real profit. Increase in money transfers since 9-11 even though we know the 9-11 hijackers got their money transferred through Western Union. Options we need to keep open. Chip cards, internet transfer. If I want you to build me a house: if I want to write a contract with you to pay you when it is finished, if I specify that payment in gold or Danish kroners or CPI-indexed--it's legal now. If the dollar and inflation got out of hand, the courts would enforce those contracts? Hugh McCulloch AER article said these contracts are now enforceable. Quietly been told that rules against commercial banks in the United States issuing currency have been repealed. Suppose no bank wants to stick its neck out and compete with the Fed. |
| 1:10:42 | Fear the Boom and Bust: Rap. Mono version. Stereo version available and video available at EconStories.tv |

COMMENTS (39 to date)

[Latest Comment](http://www.econtalk.org/cgi-bin/printblog.pl#c99892)

**Dan**writes:

Is that Mike Munger driving the limo around 1:10?

Epic music video Russ. So much win.

Posted [February 1, 2010 7:37 AM](http://www.econtalk.org/cgi-bin/printblog.pl#c97323)

[**Greg Ransom**](http://hayekcenter.org/)writes:

Hayek provides two additional causal pictures of the business cycle, different from the ones mentioned by White.

#1. In his 1929 \_Monetary Theory and the Trade Cycle\_, Hayek provides an account where an unsustainable \_private\_ bank and \_private\_ business almost bandwagon or pyramid like expansion of credit and leverage leads to a boom / bust cycle with no role for a central bank in the story.

See part IV of \_Monetary Theory and the Trade Cycle\_:

http://mises.org/story/3121#IV

#2. In his 1939 \_Profits, Interest and Investments and Other Essays on The Theory of Industrial Fluctuations\_ Hayek provides an account where sticky high wages and flexible low profit drive the causal mechanism of the business cycle, with interest rates assumed to be fixed. Changing profit margins and the substitution of capital for labor are the central causal elements.

I'm guessing Larry is well aware of these non-central bank-based Hayekian causal accounts of the business cycle.

Posted [February 1, 2010 11:27 PM](http://www.econtalk.org/cgi-bin/printblog.pl#c97450)

**Hayek+Psych**writes:

Easily the greatest limo driver cameo since Bruno Kirby in Spinal Tap.

Well done Russ! The video looks great! I think the video might just be the gateway drug to finally get my artist fiancee hooked on EconTalk.

Posted [February 2, 2010 12:16 AM](http://www.econtalk.org/cgi-bin/printblog.pl#c97452)

**Dave**writes:

Interesting that Hayek blamed the Fed's use of consumer prices and a fear of deflation as justification for low interest rates. That same reasoning was used in 2002. See [**here**](http://www.federalreserve.gov/FOMC/minutes/20021106.htm) for a FOMC reference to deflation:

"Indeed, the prospect of some persisting slack in resource use over coming quarters pointed to further disinflation. In this regard, some members referred to the possibility, which they viewed as remote, of a period of deflation in the event of a strongly negative demand shock."

Good thing we avoided that deflation...

Ben Bernanke admits the fear [**here**](http://www.ritholtz.com/blog/2010/01/monetary-policy-and-the-housing-bubble/) as well:

"The aggressive monetary policy response in 2002 and 2003 was motivated by two principal factors... Second, the FOMC’s policy response also reflected concerns about a possible unwelcome decline in inflation. Taking note of the painful experience of Japan, policymakers worried that the United States might sink into deflation and that, as one consequence, the FOMC’s target interest rate might hit its zero lower bound, limiting the scope for further monetary accommodation. FOMC decisions during this period were informed by a strong consensus among researchers that, when faced with the risk of hitting the zero lower bound, policymakers should lower rates preemptively, thereby reducing the probability of ultimately being constrained by the lower bound on the policy interest rate."

Posted [February 2, 2010 1:07 AM](http://www.econtalk.org/cgi-bin/printblog.pl#c97455)

**emerich**writes:

Interesting podcast. What is there about the Hayekian model that's incompatible with mainstream models? It doesn't seem inconsistent with a Friedmanite monetarist view, or Taylor. You didn't mention that poor Hayek didn't have the data to know that the money supply in the 30's had contracted so drastically, any more than anyone else did. Surely part of the problem with Keynes's prescription is that he too was addressing a problem whose cause wasn't evident at the time. It took Friedman and Schwartz to document it.

The rap song is well done and fun but I don't know if it can become more than an inside joke. That is, I'd be surprised if it becomes viral with the young set. For those who know nothing about economics, which is most of them, I suspect it will be meaningless. I'll see what my teenage kids say and let you know. Certainly worth experimenting with new channels to get fundamental econ concepts more widely circulated. Have you seen PJTV? Possibly a good model.

Posted [February 2, 2010 8:08 AM](http://www.econtalk.org/cgi-bin/printblog.pl#c97474)

[**Daniel Klein**](http://economics.gmu.edu/klein/index.html)writes:

Excellent, thoughtful discussion. I learned from it.

Posted [February 2, 2010 8:16 AM](http://www.econtalk.org/cgi-bin/printblog.pl#c97475)

**Nathan**writes:

I have a hard time swallowing the assertion that the government selling more short-term debt makes it more motivated to avoid inflation. Seems a bit like being happy your football team is pinned back at the two-yard line because that makes them really motivated to avoid a safety.

Posted [February 2, 2010 9:21 AM](http://www.econtalk.org/cgi-bin/printblog.pl#c97478)

[**Greg Ransom**](http://hayekcenter.org/)writes:

Hayek has 2 other causal accounts of the boom and bust -- neither of which invoke the center bank.

See \_Monetary Theory and the Trade Cycle\_, part IV where the artificial boom is a bandwagon / pyramid of expanding credit and leverage, and expanding expectations, all generated internally in the private banking and business sectors, and not produced as a result of mistakes or actions by a central bank.

Then see \_Profits, Interests & Investments\_ were falling profits and sticky high wages produce the boom and bust (with interest rates assumed fixed), and the substitution of capital for labor is at the center of the story.

Posted [February 2, 2010 10:24 AM](http://www.econtalk.org/cgi-bin/printblog.pl#c97485)

[**Doug Utberg**](http://www.businessoflifellc.com/)writes:

The rap video on Youtube is outstanding!!!

I nearly lost it when I saw Mike Munger as the Limo Driver. Great work.

Posted [February 2, 2010 7:14 PM](http://www.econtalk.org/cgi-bin/printblog.pl#c97538)

**Kelly**writes:

First time I've heard the podcast (didn't have the right Ipod before) and I found it very interesting. The rap at the end sealed the deal for me downloading it every week though (and no I didn't fast forward to get to it)!! Nicely done!! I'm hoping for a song only download that I can share with friends :)

I'm a little sad I can't find the video you're all talking about on youtube though :(

Thanks for the insights!

[Kelly: The youtube version is at [**http://www.youtube.com/watch?v=d0nERTFo-Sk**](http://www.youtube.com/watch?v=d0nERTFo-Sk). It's the same as the one at [**http://econstories.tv/home.html**](http://econstories.tv/home.html) --Econlib Ed.]

Posted [February 2, 2010 8:58 PM](http://www.econtalk.org/cgi-bin/printblog.pl#c97551)

**DM**writes:

I must have misread ”Price and Production”. It is my understanding that inflation rather SHORTENS, and not increases the number of stages of production, as well as forcing the capital to be reallocated toward the final and away from the initial stages of production, outbidding for labor and recourses, and that results in miss investments.
As money becomes cheap, consumers increase spending and abandon savings, putting pressure on producers of consumer goods, that’s why we have too many houses build, too many cars, and so on. Am mistaken in my understanding of Hayek’s explanation of Booms and Busts here?

Posted [February 2, 2010 9:03 PM](http://www.econtalk.org/cgi-bin/printblog.pl#c97552)

[**Greg Ransom**](http://hayekcenter.org/)writes:

DM -- in P&P both of these happen, consumption increases and the period of production lengthens at the same time. This makes everything unsustainable. You get more short term "late stage" production and more long term "early stage" production. But people haven't refrained from consumption in order to provide the additional resources necessary to complete all of these production processes at expected costs and profits margins.

DM writes.

"I must have misread ”Price and Production”....

Posted [February 2, 2010 10:45 PM](http://www.econtalk.org/cgi-bin/printblog.pl#c97566)

**DM**writes:

Greg,
Thank you for your explanation. At this point I’m going to disagree with you on the statement that as consumption increases (increased demand for consumer goods) the period of production lengthens.
You do get more short term “late stages” and that “more” is what does a lot of investors” in” when prices become unsustainable, but you do not see more long term “early stage” as they become less profitable compare to the late stages.
However when people invest VOLUNTARILY savings, therefore delaying the immediate consumption it depresses prices of consumer goods and increases prices of production goods “leveling out” profit margins between different stages, therefore making it more profitable to invest in earlier stages. And as Hayek says “…The general narrowing of the price margins between the stages of production will even make it possible to start production in new and more distant stages which have not been profitable before…”; which is contrary to my understanding of this podcast, stating that the additional money is responsible for more capitalistic ways of production. I find this statement to be incorrect in understanding the price mechanism on the course of the credit cycle as offered by Hayek.
But then again, I may very well just be missing something here.

DM

Greg Ransom writes:

DM -- in P&P both of these happen, ...

Posted [February 3, 2010 12:35 AM](http://www.econtalk.org/cgi-bin/printblog.pl#c97572)

**Ward**writes:

If the Central Bank caused malinvestment in the long period of low interest rates after the tech bust why didn't long rates that are set by the markets react? Is there an Austrian explanation for Greenspan's conundrum?

Posted [February 3, 2010 10:36 AM](http://www.econtalk.org/cgi-bin/printblog.pl#c97629)

[**Tom Vest**](http://www.eyeconomics.com/)writes:

It sounded to me like White first claimed that the velocity of money (V) is intrinsically difficult to measure, and so any central bank manipulation of the money supply (M) to compensate for unwelcome shifts in V would be ad hoc and pointless, if not absolutely counterproductive. But then a few minutes later he advocated the complete privatization of the banking system, because individual "bankers" (which, in this scenario would mean anyone who chose to establish their own private bank) would naturally be able to solve that same problem, and do so on a continuous rolling basis, indefinitely.

Is that a contradiction? If that contradiction were resolved with the imposition of unlimited personal liability, wouldn't that remedy simply result in the abandonment of the statistical multiplexing of monetary stocks (i.e., fractional reserve banking), and so the disappearance of banking as we know it?

Posted [February 3, 2010 12:07 PM](http://www.econtalk.org/cgi-bin/printblog.pl#c97641)

**Greg Ransom**writes:

This isn't the usual pattern, this is the artificial boom pattern.

DM writes:

"At this point I’m going to disagree with you on the statement that as consumption increases (increased demand for consumer goods) the period of production lengthens."

Posted [February 3, 2010 12:13 PM](http://www.econtalk.org/cgi-bin/printblog.pl#c97643)

**Juan Carlos**writes:

many models of international trade, including ricardo's comparative advantage model take labor and capital as homogeneous and derive the gains from trade from the fact that labor and capital can be reallocated to more productive uses.
Krugman writes, in a piece called 'Ricardo´s difficult idea' that:
"Wages are determined in a national labor market: The basic Ricardian model envisages a single factor, labor, which can move freely between industries. When one tries to talk about trade with laymen, however, one at least sometimes realizes that they do not think about things that way at all. They think about steelworkers, textile workers, and so on; there is no such thing as a national labor market. It does not occur to them that the wages earned in one industry are largely determined by the wages similar workers are earning in other industries"

What would austrian theory say about that? is ricardo's aggregation wrong? is his model, therefore, misleading? austrian theory seems to suggest the inability - or some inability- of capital and labor to reallocate

Posted [February 3, 2010 3:18 PM](http://www.econtalk.org/cgi-bin/printblog.pl#c97663)

[**Lawrence H. White**](http://www.divisionoflabour.com/)writes:

Some responses to the interesting discussion so far.

1) The rap song is great; even better is the video. One quibble with the video is that in real life Hayek (b. 1899) was younger than Keynes (b. 1883).

2) Greg Ransom is correct about Hayek's additional cycle scenarios. I should have said that he had two scenarios \*that make sense to me\*. I've criticized (History of Political Economy, Winter 1999) Hayek's notion of spontaneous joint overissue by competing banks. And I have a hard time making sense of his 1939 account.

3) I agree that John Taylor has been sounding Hayekian lately. Anna Schwartz also. But Hayek's and Friedman's cycle theories are "incompatible" in that Friedman relegated interest rate and investment distortions to the sidelines as of no real historical importance. There is no "credit bubble" story in Friedman, but rather a short-run/long-run Phillips Curve story. See Roger Garrison's paper "Hayek and Friedman, Head to Head".

4) I don't think it's a contradiction to say the decentralized banks issuing redeemable money have informational feedback on their clients' money-holding (and incentives to respond to it) that a monopoly central bank lacks.

Posted [February 3, 2010 6:03 PM](http://www.econtalk.org/cgi-bin/printblog.pl#c97688)

**Michael M**writes:

Lawrence! Now you just need to get him and Selgin on for one big podcast about free banking. Something that goes a bit more in-depth, perhaps, than the one you had with Selgin a while ago.

That is right up there with having a real Keynesian on the podcast as far as my dream casts go.

[Minor clarification: Michael M is a different person from frequent podcast guest Mike Munger.--Econlib Ed.]

Posted [February 3, 2010 7:14 PM](http://www.econtalk.org/cgi-bin/printblog.pl#c97693)

[**Tom Vest**](http://www.eyeconomics.com/)writes:

Thanks to Prof. White for the response!

FWIW I concur, based on experience managing extremely variable flows in another highly decentralized, highly opaque industry that depends on statistical multiplexing, that strong(er) incentives and better local information do make a difference. However, I can also say that the incentives in that context are not sufficient to inspire the uniform, continuous maintenance of sufficient "precautionary capacity" to offset every possible risk -- to do that a provider would need to effectively forego most if not all of the efficiency/productivity gains that are made possible by the use of statmux techniques (i.e., in banking terms, to maintain anything less than 100% reserves). Also, experience in that other domain suggests that the kind of events that cause major disruptions in local demand patterns are rarely local in origin -- and given the technical as well as institutional impediments to transparency, they frequently arrive with no advance warning. These experiences suggest to me that unless interbank flows and bank customer sentiments also came to be as compartmentalized as the decentralized banks and currencies themselves, such remote events would still have effects (and often come as a big surprise) under a free banking system...

Posted [February 4, 2010 10:01 AM](http://www.econtalk.org/cgi-bin/printblog.pl#c97839)

[**Tom Vest**](http://www.eyeconomics.com/)writes:

One last question. I wonder if Prof. White has considered the impact of a migration to free banking on international trade and investment flows? Some years ago Lawrence Broz wrote a couple of articles in IO that argued that the dominant private banks that pre-dated the Fed willingly entered into the current system, and voluntarily foreswore various "free banking-like" prerogatives that they had enjoyed up to that point, ONLY out of a desire to make the $US sufficiently acceptable for use in lucrative and rapidly growing international trade and investment transactions. Prior to that time, the $US was considered too unreliable by trade partners, and as a result all cross-border transactions had to be denominated in pounds sterling, francs, etc. In a future where US communities served by various private currencies continued to participate in substantial inbound and outbound trade and FDI exchanges, would those communities be better or worse off than under the current nationally coordinated banking system? How would a free banking system impact their prospects?

Posted [February 4, 2010 10:19 AM](http://www.econtalk.org/cgi-bin/printblog.pl#c97841)

[**Adam**](http://sophistpundit.blogspot.com/)writes:

Excellent podcast. I read Selgin's *Theory of Free Banking* after he appeared on EconTalk, and that's when I learned about White's work. So I was excited to learn about when he came to GMU--and this was probably the best and clearest explanation of Hayek's theory of the business cycle I've heard yet.

Posted [February 4, 2010 11:41 AM](http://www.econtalk.org/cgi-bin/printblog.pl#c97847)

[**vimothy**](http://vimothy.wordpress.com/)writes:

Very interesting podcast, as always. I do hope that we will get to hear from a Keynesian in response!

I think that one of the reasons that Austrians are not remembered for their macro is that they were much better at micro. Keynes both frames the macro question and answers it.

The problem is that if total expenditure equals total income, any reduction in aggregate spending reduces income. Scott Sumner in his podcast discussed the financial crisis in terms of a massive drop in nominal GDP. Since nominal GDP is total expenditure is total income, this is just another way of framing the identity I gave at the top of the paragraph.

So by definition, there is too little aggregate demand. We could talk about reduced aggregate demand in terms of savings: income minus expenditure. On aggregate, savings can only increase if output remains constant, which is simply yet another way of saying the identities we've already set up. So the paradox of thrift is really a tautology. If private sector savings increase then nominal GDP will decrease and the desire of the private sector will be frustrated...

Unless (closed economy) there is government deficit spending. That's why people still talk about it, because its the only thing that can allow the private sector to increase its savings without plunging us into a depression.

The reason why this is so is in the identities we're discussing. Within a sector, all balances must sum to zero, since by double entry bookkeeping there are two sides to every transaction. Therefore, for a sector to *net* save, there has to be someone on the other side of that transaction net spending. The net financial assets it's acquiring have to come from somewhere. In an open economy, they could come from the foreign sector (the balance of payments), or the government. But they have to come from somewhere.

If I remember correctly Steve Fazzari's podcast addressed some of these issues, but it would be nice nonetheless to hear a response to Larry & Hayek from a Keynesian.

Posted [February 4, 2010 2:22 PM](http://www.econtalk.org/cgi-bin/printblog.pl#c97860)

**vimothy**writes:

Sorry, that should read:

"Therefore, for a sector to net save, there has to be someone on the other side of *the balance sheet* net spending."

Posted [February 4, 2010 2:25 PM](http://www.econtalk.org/cgi-bin/printblog.pl#c97861)

**emerich**writes:

vimothy, there are many reasons to think Keynes' analysis was flawed. For example, in the Keynesian model investment doesn't rise if savings do, but that's probably false. He created a model to explain a puzzle to which he was missing the largest piece--knowledge of the 1/3 decline in the money supply in the US in the early 30s. If I recall correctly, the real interest rate rose in the first half of the 30's since deflation made the low nominal rates high in real terms. A key critique of Keynes by Friedman was that Keynes considered only nominal magnitudes, not real ones.

Posted [February 4, 2010 2:51 PM](http://www.econtalk.org/cgi-bin/printblog.pl#c97865)

**vimothy**writes:

Assume the tin opener!

But this (Say's Law and the relationship of investment to saving) is a key theme of Keynes' work. He certainly addresses it (have a look at the Wikipedia entry for Keynesian economics--unfortunately I can find no mention of it in Alan Blinder's otherwise very good entry in the CEE). Briefly, just because you have an ex post accounting identity, it doesn't mean that good investments will appear at every level of savings. There is also another problem with the loanable funds--it makes assumptions about causality that may or may not be correct.

But in any case it still remains true that "measured at current prices, the government’s budget deficit less the current account deficit is equal, by definition, to private saving net of investment." (Wynne Godley). Remember that it's the acquisition of *net financial assets*.

I'm not sure I follow your point about Friedman, but "a drop in the money supply" is just another way of saying what we've already said with our NIPA identities.

Posted [February 4, 2010 3:43 PM](http://www.econtalk.org/cgi-bin/printblog.pl#c97871)

**vimothy**writes:

I suppose what Friedman gives you that you don't necessarily get from Keynes is a reason to blame the Fed specifically. However, it does rely on the Fed controlling the money supply. Did it? It doesn't today, but I don't know enough about the historical gold standard system to know if it did then.

Perhaps we could ask Larry, who is the expert, after all...?

Posted [February 4, 2010 3:57 PM](http://www.econtalk.org/cgi-bin/printblog.pl#c97873)

**Scott M**writes:

Great rap video! As for competing currencies, maybe it will develop outside [**the banking system.**](http://articles.moneycentral.msn.com/Banking/BetterBanking/struggling-towns-printing-their-own-cash.aspx)

Posted [February 4, 2010 8:17 PM](http://www.econtalk.org/cgi-bin/printblog.pl#c97927)

**Greg Ransom**writes:

Note well that Hayek's account of the problem of macro is endorsed by Lucas -- and Keynes explicitly endorsed Hayek's account of macro as a money problem. Much of the dis'ing of Hayek's central role in the history of modern econ is simply a product of a massive ignorance of the history of econ thought -- which is pandemic among the professors of economics.

Someone wrote:

"I think that one of the reasons that Austrians are not remembered for their macro is that they were much better at micro. Keynes both frames the macro question and answers it."

Posted [February 5, 2010 12:13 AM](http://www.econtalk.org/cgi-bin/printblog.pl#c97938)

[**Tom Vest**](http://www.eyeconomics.com/)writes:

To Scott W's comment about currencies developing outside of the the banking system:

Indeed, small isolated experiments like this will probably remain a recurring phenomenon, and might even increase somewhat in frequency and scope if current uncertainties about the monetary system persist. But these experiments -- both the successes and the failures -- tend to reinforce the point made earlier about the "abandonment of the productivity/efficiency gains made possible by statistical multiplexing" (aka the fractional reserve system). Without the added liquidity that statmux supports, it seems that currencies tend to wither and die (as in the anecdote from your linked article) -- and \*with\* the application of statmux techniques, their persistence over time is made possible, but only at the price of creating certain intrinsic/unavoidable systemic risks that can only mitigated through (perhaps very limited) coordinated action.

For another illustrative "outside the banking system" example, see http://www.slate.com/id/1937/

Posted [February 5, 2010 8:42 AM](http://www.econtalk.org/cgi-bin/printblog.pl#c97959)

**Travis**writes:

Just something random that I was thinking (as a community banker) while you were discussing the impact of interest rates on production.

Real Estate booms are the ultimate sector to be affected by artificially low interest rates because they are crucial to the decision making of both the manufacturer (the developer, home builder) and the consumer (home buyer). Both sides are directly impacted.

Consider that a P&I mortgage payment is the same for someone buying a 300,000 house at 7.5% as it is for someone buying a $370,000 house at 5.5%.

Because consumers pick a payment that they can afford (as opposed to a home price), that means home prices just rose 23% with only a 200 bp difference in the artificial and market-derived interest rate. I would think that the home sector is the ultimate example of malinvestment due to rate. And that doesn't even touch on a developer's NPV calculations.

Sorry for the random thought, but it seems like most only use manufacturing for their example of Hayek's theories (because that's what he used), but if you bring it to the modern day situation you can really see how true it is.

Posted [February 5, 2010 6:51 PM](http://www.econtalk.org/cgi-bin/printblog.pl#c98012)

**Pingry**writes:

If Lawrence White believes that the Fed caused the financial crisis, then where is the statistical evidence?

Bring it on......

If you make a claim, then the least you should do is attempt to subject it to proper statistical testing.

Seriously, bring it on.

--Pingry

Posted [February 7, 2010 10:06 PM](http://www.econtalk.org/cgi-bin/printblog.pl#c98205)

**AHBritton**writes:

Russ,

I love hearing about the Austrian perspective and free-banking. It seems maybe it's time for a little balance. You have had a number of people on to defend free banking and/or the gold standard, and I actually still think this could be explored more. White touches on it, but I have heard few explanations of the mechanisms by which we would smoothly move to such a system.

More importantly, however, I don't think you've had a SINGLE advocate for central banking on the program. Since it is the dominant system in almost every country on earth I would assume there are some out there to be found, even in this anti-Bernanke atmosphere. Tom Vest has made some good arguments, similar to things I have tried to say, although I must admit he sounds much more knowledgeable and articulate on the matter. My main question was, isn't there a benefit in decreased transaction costs (especially with international transactions) with a central banking system? Like I said, Tom's questions seem more elucidated.

Also another Keynesian or two would be nice. Although I find many Austrian critiques of Keynesianism compelling, I still feel there are certain aspects that seem unaddressed or unclear to me. I think Vimothy makes some good illustrations of this, if somewhat a little jargon-y for me.

And while I'm giving out podcast advice, I would love to hear maybe an occasional debate/panel style podcast. I would be devastated if you stopped doing the one on one in-depth style you've developed, but maybe you could have and occasional 2-on-1, or 2-on-2, or maybe just 1-on-1 with you as the moderator. Similar to your current podcast, going in-depth in the long format style, but with more of a debating, or competing theories, type feel.

Thanks again for another great podcast!

Posted [February 8, 2010 4:00 PM](http://www.econtalk.org/cgi-bin/printblog.pl#c98328)

**Tushar**writes:

Dear Russ - the podcast was extremely informative. Though I don't comment much; I listen to econtalk every week. This week, since there was an added element to it which was the rap song :), I had to write back. Fantastic song! And please continue the good work!!

Posted [February 9, 2010 1:18 AM](http://www.econtalk.org/cgi-bin/printblog.pl#c98442)

**Doug**writes:

A great podcast. I was interested in the ideas expressed towards the end of the podcast about alternative types of modern money and the constraints they impose on controlling the money supply. I would be interested in hearing about how electronic banking/money relates to this issue e.g. internet banking, credit cards, payments by mobile phone etc.

What seemed unclear to me was what system (free or regulated banking) would be more robust in a financial crisis? I would have welcomed more of a debate on this.

The rap is terrific! I look forward to seeing more.

Posted [February 10, 2010 2:13 PM](http://www.econtalk.org/cgi-bin/printblog.pl#c98582)

**John Thurow**writes:

Is the shot you hear at the end of the "Boom and Bust" rap an economist committing suicide?

My aside -hopefully the Keynesian....

Posted [February 11, 2010 7:51 AM](http://www.econtalk.org/cgi-bin/printblog.pl#c98644)

**Gandydancer**writes:

"...payment in gold or Danish kroners or CPI-indexed--it's legal now. If the dollar and inflation got out of hand, the courts would enforce those contracts? Hugh McCulloch AER article said these contracts are now enforceable."

Got a link to that article? I'd guess that if such contracts threatened to became common defenders of the Fed Note's status as legal tender would rapidly end the enforcability... but I'd still like to look at McCulloch.

Posted [February 12, 2010 10:01 AM](http://www.econtalk.org/cgi-bin/printblog.pl#c98784)

**Ben Russell**writes:

First of all, I love the podcast and the rap Prof. Roberts, keep up the good work!!!

Being very much a rookie at this level of macro I'm not sure if my comment will make much sense, but I figured I'd throw it out there anyway. Near the end of the podcast, when the discussion turned to free-banking, Prof. White made the following statement, *"[...it provides a useful incentive for you to] monitor your bank and don't rely on other people to monitor it for you."* I'm assuming that this is because individuals incentives are much better aligned to accurate knowledge/tracking/reporting of bank solvency, as compared to a central regulator or third party contractor.

While in theory this argument makes sense the seeming practical difficulty for me is how can individuals realistically keep track of the relative solvency of various banks. Particularly when, from my sense of the world today, so many (expensive) professionals are employed around the world trying to accurately keep track of bank solvency across the globe. In what is seemingly an era of increasing complexity and specialization this seems to me to be a pretty difficult task to ask of all individuals in a society.

I would love to hear how and why I'm wrong on this issue as it is something that I had questions and concerns about.

Thanks

Posted [February 24, 2010 1:47 AM](http://www.econtalk.org/cgi-bin/printblog.pl#c99891)

**Ben Russell**writes:

Also, along with a few other comments before me, I want to echo the desire to have a Keynesian on the podcast, so that we can hear at least some of the other side of the story.

Thanks

Posted [February 24, 2010 1:50 AM](http://www.econtalk.org/cgi-bin/printblog.pl#c99892)

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