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A Classic Hayekian Hangover

by Roger Garrison and Gene Callahan

Do busts follow investment booms as hangovers follow drinking binges? Dubbing the idea "The Hangover Theory" (*Slate,* December 3, 1998), Paul Krugman has attempted to denigrate the business-cycle theory introduced early last century by Austrian economist Ludwig von Mises and developed most notably by Nobelist F. A. Hayek.

Yet proponents of the Austrian theory have themselves embraced this apt metaphor. And if investment is the intoxicant, then the interest rate is the minimum drinking age. Set the interest rate too low and there is bound to be trouble ahead.

The metaphorical drinking age is set by—and periodically changed by—the Federal Reserve. In our Fed-centric mixed economy, the understanding that "the Fed sets interest rates" has become widely accepted as a simple institutional fact. But unlike an actual drinking age, which has an inherent degree of arbitrariness about it, the interest rate cannot simply be set by some extra-market authority. With market forces in play, it has a life of its own.

The interest rate is a price. It's the price that brings into balance our eagerness to consume now and our willingness to save and invest for the future. The more we save, the lower the market rate. Our increased saving makes more investment possible; the lower rate makes investments more future-oriented. In this way, the market balances current consumption and economic growth.

Price-fixing foils the market. Government-mandated ceilings on apartment rental rates, for instance, create housing shortages, as is well known by anyone who has gone apartment hunting in New York City. Similarly, a legislated interest-rate ceiling would cause a credit shortage: The volume of investment funds demanded would exceed people's actual willingness to save.

But the Fed can do more than simply impose a ceiling on credit markets. Setting the interest rate below where the market would have it is accomplished not by decree but by increasing the money supply, temporarily masking the discrepancy between supply and demand. This papering over the credit shortage hides a problem that would otherwise be obvious, allowing it to fester beneath a binge of investment spending.

An artificially low rate of interest, then, sets the economy off on an unsustainable growth path. During the boom, investment spending is excessively long-term and overly optimistic. Further, high levels of consumer spending draw real resources away from the investment sector, increasing the gap between the resources actually available and the resources needed to see the long-term

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and speculative investments through to completion.

Save more and we get a market process that plays itself out as economic growth. Pump new money through credit markets and we get a market process of a very different kind: It doesn't play itself out; it does itself in. The investment binge is followed by a hangover. This is the Austrian theory in a nutshell. (Ironically, it is the theory that Alan Greenspan presented 40 years ago when he lectured for the Nathaniel Branden Institute.) We believe that there is strong evidence that the United States is now in the hangover phase of a classic Mises-Hayek business cycle.

In recent years money-supply figures (M_1, M_2, etc.) have become clouded by institutional and technological change. But in our view, a tale-telling pattern is traced out by the MZM data reported by the Federal Reserve Bank of St. Louis. ZM standing for "zero maturity," this monetary aggregate is a better indicator of credit conditions than are the more narrowly defined M's.

Credit-Creation Binge

After increasing at a rate of less than 2.5 percent during the first three years of the Clinton administration, MZM increased over the next three years (1996–1998) at an annualized rate of over 10 percent, rising during the last half of 1998 at a binge rate of almost 15 percent.

Sean Corrigan, a principal in Capital Insight, a UK-based financial consultancy, details the consequences of the further expansion that came in "autumn 1998, when the world economy, still racked by the problems of the Asian credit bust over the preceding year, then had to cope with the Russian default and the implosion of the mighty Long-Term Capital Management."

Corrigan goes on: "Over the next eighteen months, the Fed added $55 billion to its portfolio of Treasuries and swelled repos held from $6.5 billion to $22 billion… [T]his translated into a combined money market mutual fund and commercial bank asset increase of $870 billion to the market peak, of $1.2 trillion to the industrial production peak, and of $1.8 trillion to date [August 14, 2001]—twice the level of real GDP added in the same interval" (http://mises.org/fullarticle.asp?control=754).

The party was in full swing. The Fed cut the fed funds rate 100 basis points between June 1998 and January 1999. The rate on 30-year Treasuries dropped from a high of over 7 percent to a low of 5 percent. Stock markets soared. The NASDAQ composite went from just over 1000 to over 5000, rising over 80 percent in 1999 alone. With abundant credit being freely served to Internet start-ups, hordes of corporate managers, who had seemed married to their stodgy blue-chip companies, suddenly were romancing some sexy dot-com that had just joined the party.

Consumer Spending Strong

Meanwhile consumer spending stayed strong—with very low (sometimes negative) savings rates. Growth was not being fueled by real investment, which would require forgoing current consumption to save for the future, but by the monetary printing press.

As so often happens at bacchanalia, when the party entered the wee hours, it became apparent that too many guys had planned on taking the same girl home. There were too few resources available for all of their plans to succeed. The most crucial—and most general—unavailable factor was a continuing flow of investment funds. There also turned out to be shortages of programmers, network engineers, technical managers, and other factors of production. The rising prices of these factors exacerbated the ill effects of the shortage of funds.

The business plans for many of the start-ups involved negative cash flows for the first ten or 15 years while they "built market share." To keep the atmosphere festive, they needed the host to keep filling the punch bowl. But fears of inflation led to Federal Reserve tightening in late 1999, which helped bring MZM growth back into the single digits (8.5 percent for the 1999–2000 period). As the punch bowl emptied, the

hangover—and the dot-com bloodbath—began. According to research from Webmergers.com, at least 582 Internet companies closed their doors between May 2000 and July 2001. The plunge in share price of many of those still alive has been gut wrenching. The NASDAQ retraced two years of gains in a little over a year.

During the first half of 2001, the Fed demonstrated—with its half-dozen interest-rate cuts and a near-desperate MZM growth of over 23 percent—that you can't recreate euphoria in the midst of a hangover.

It all adds up to the Austrian theory. As a final twist to our story, we note that Krugman, who previously could only mock the Austrians, has recently given us an Austrian account of our macroeconomic ills. In his "Delusions of Prosperity" (*New York Times,* August 14, 2001), Krugman explains how our current difficulties go beyond those of a simple financial panic:

> We are not in the midst of a financial panic, and recovery isn't simply a matter of restoring confidence. Indeed, excessive confidence [fostered by unduly low interest rates maintained by rapid monetary growth?] may be part of the problem. Instead of being the victims of self-fulfilling pessimism, we may be suffering from self-defeating optimism. The driving force behind the current slowdown is a plunge in business investment. It now seems clear that over the last few years businesses spent too much on equipment and software and that they will be cautious about further spending until their excess capacity has been worked off. And the Fed cannot do much to change their minds, since equipment spending [at least when such spending has already proved to be excessive] is not particularly sensitive to interest rates.

With Krugman on the verge of rediscovering the policy-induced self-reversing process that we call the Austrian theory of the business cycle, we confidently claim that current macroeconomic conditions are best described as a classic Hayekian hangover. The Austrian theory, of course, gives us no policy prescription for converting this ongoing hangover into renewed euphoria. But it does provide us with the best guide for avoiding future ones. □

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